“We Have To Live With It” -- Tips From The Litigators’ Perspective On Advanced Drafting

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INTRODUCTION

To a significant degree, what a trial lawyer’s experience brings to the drafting of franchise agreements is some observations on what language did not work and what additional provisions would have been helpful. That is because the trial lawyer’s purpose, if he or she were the original drafter of the agreement, would be very much the same as the counselor’s: clarity, predictability, completeness, flexibility, foresight and a due regard for the special issues arising from the industry in which the client operates and from the client’s particular business model. However, there is nothing like the scrutiny and crash-testing that comes with a trial to bring out previously unperceived ambiguity in what had appeared to be clear contractual language, an appreciation for the practical complexity of contract enforcement mechanics, and a sense that it all would have been much easier if the contractual language at issue had gone one step further in terms of what it explicitly addressed.

Virtually any provision of a franchise agreement can become important in franchise relationship litigation. Every provision is there for a reason -- to allocate rights or responsibilities in some way -- and thus each is potentially subject to some jockeying between the parties as to exactly how far that right or responsibility was intended to extend. Certain provisions, however, seem to be the subject of more litigation than others, and we focus below on some of them.

In line with the specific topic of this paper, we will not try to discuss every aspect of the drafting of the provisions we address. There have been a number of excellent papers by Forum members in recent years that have focused in some detail on the overall drafting of franchise agreement provisions (see, e.g., Fittante and Wieczorek, Advanced Drafting, A.B.A. Forum on Franchising (A.B.A. Oct. 6-8, 2004)), and we will not try to repeat their many useful observations here. Rather, we will try to add some specific suggestions and insights arising from our experience in litigation dealing with these provisions.

Finally, we cannot tell the draftsman how any particular franchisor’s franchise agreement should be written. Much depends on the client’s business, management personality and level of risk aversion. What we can do is raise some issues to consider and in some cases present models which can serve as a template for further discussion and consideration.¹

I. DEFAULT AND TERMINATION PROVISIONS

A. Material Breach Or Failure Of A Condition

One franchise agreement drafting issue that has not seemed to get the attention it deserves is the effect of the use of the term “material breach” (or, you might say, the consequences of living “in a material world”). A franchise agreement might say: “This franchise agreement may be terminated for any material breach by the franchisee.” That language, however, does no more than state what the law would be in the absence of that language. Many draftsmen who use that phrase -- “material breach” -- may not appreciate the nature of the inquiry they may be invoking. Section 241 of Restatement (Second) of Contracts (1981) states:

¹ Sections I-IV of this paper were prepared by Mr. Klarfeld, Sections V-IX were prepared by Mr. Carden.
In determining whether a failure to render or to offer performance is material, the following circumstances are significant:

(a) the extent to which the injured party will be deprived of the benefit which he reasonably expected;

(b) the extent to which the injured party can be adequately compensated for the part of that benefit of which he will be deprived;

(c) the extent to which the party failing to perform or to offer to perform will suffer forfeiture;

(d) the likelihood that the party failing to perform or to offer to perform will cure his failure, taking account of all the circumstances including any reasonable assurances;

(e) the extent to which the behavior of the party failing to perform or to offer to perform comports with standards of good faith and fair dealing.

This is the test for the right to cancel a contract for total breach. Is that really the nature of the inquiry intended by franchisors' drafting counsel when they use that term?

What most drafters of franchise agreements are trying to do is to define circumstances under which the franchisor can terminate the agreement whether or not the conduct by the franchisee would meet the classic test for a “material breach.” The listing of these circumstances also serves as a notice to the franchisee of particular conduct that can result in termination of the agreement without the wide-ranging balancing of interests and factors that might lead to uncertainty as to the potential consequences. As stated in 13 Corbin on Contracts § 68.9 (Matthew Bender & Co. 2005):

The purpose and goals of limiting the right to terminate in the context of an exclusive dealing, distributorship, or franchise agreement are not only to provide a means for the manufacturer or seller to protect its trademark or service mark, and its corresponding good will but also to protect the buyer, distributor, or franchisee from a forfeiture of its investment of money, time, and skill by arbitrary termination by the manufacturer. These goals and purposes are clearly distinguishable from the right to cancel for total breach of the agreement. These two rights coexist.

Thus, what most franchise agreement drafters are attempting to do is list events which, if they occur, discharge the franchisor's duty of further performance without arguing about how that event fits into the greater scheme of things. While from the trial lawyer's perspective it will always be easier to defend a termination where the franchisee’s conduct was egregious, that is not a burden of proof that you want. Rather, what you want is what are known in contract law as “conditions.” As stated in E. Allan Farnsworth, Farnsworth on Contracts § 8.2 (2d ed. 2001):
Although a condition is usually an event of significance to the obligor, this need not be the case. In exercising their freedom of contract, the parties are not fettered by any test of materiality or reasonableness.

See also Restatement (Second) of Contracts § 237, Cmt. a (1981) (rules of discharge “are, of course, subject to variation by agreement of the parties”). Where all of this leads for franchise agreement drafters is that they should consider drafting the portion of a termination provision listing the specific acts of the franchisee that will justify termination in the language of “condition” rather than that of “breach.”

This is a harsh rule, and courts will be inclined to interpret away from it if given the opportunity. See Farnsworth, § 8.4. But if it is clear that the franchisee has assumed the risk of losing its license upon the occurrence of an event that was under its control, a clear condition should be honored. Restatement (Second) § 227(1) (1981). There are still going to be limits (e.g., unconscionability), but reasonable implementation (and in particular an opportunity to cure where appropriate) should support enforceability.

B. Inclusion Of Incurable Defaults

Franchisee defaults under a franchise agreement (whether viewed as breaches or as failures of conditions) are of two types. If the default is curable, an opportunity to cure makes sense from the franchisor’s perspective in terms of both efficiency and fairness. The franchisor wants to be made whole and to have the franchisee comply with its obligations going forward. However, certain types of defaults are basically incurable in the sense that they will continue to burden the franchise relationship despite the franchisee’s attempt to cure (e.g., the franchisee has made a series of deliberate misrepresentations to the franchisor). If there is a default in that category, the franchisor wants to end the relationship, and the agreement should be drafted to allow for termination without an opportunity to cure.

In drafting such a provision, the draftsman must be mindful that 16 states (and two U.S. territories) have franchise relationship laws that limit -- to one degree or another -- the circumstances under which a franchisor can terminate a franchise agreement without providing advance notice, an opportunity to cure or both. However, about two-thirds of those states expressly allow exceptions to their notice requirement in certain situations. See, e.g., Cal. Bus. & Prof. Code §§ 20020 - 20021 (1981) (allowing immediate termination in eleven circumstances); 815 Ill. Comp. Stat. § 705/19 (1988) (dispensing with opportunity to cure in four circumstances).

Thus, if a franchisor wants the opportunity to terminate in certain circumstances without affording the franchisee an opportunity to cure, that right should be expressly set out in the agreement; however, before it is implemented, the limitations of any applicable state relationships law will have to be considered.

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2 Specifically providing that each of these circumstances “shall constitute a material breach” may achieve the same result. See, e.g., All EMS, Inc. v. 7-Eleven, Inc., No. 96C6235, 2005 U.S. Dist. LEXIS 159 (N.D. Ill. Jan. 4, 2005). However, it risks confusion when a term of art is used in other than its accepted meaning.
C. Post-Termination Obligations

Termination provisions in franchise agreements typically include a section setting out specific obligations of the franchisee at the time of termination or expiration of the agreement. The standard list includes cessation of use of the franchisor’s service marks, de-identification of the formerly franchised location, and return to the franchisor of its operations manuals and other materials containing confidential information provided by the franchisor to the franchisee.

Some additional provisions that many use and others should consider include the following:

1. Transfer Of Telephone Numbers Used In Connection With The Franchised Business

In a service business where telephone communication between the franchisee and its customers is expected, the telephone numbers used by the franchisee will become identified with the franchise system. Moreover, these telephone numbers appear on business cards, letterhead and other material that will be provided to customers over the years. Most of that material will also bear the franchise system's service mark. Perhaps worst of all, those telephone numbers are likely to remain listed under the franchisor’s mark in telephone books that have already been distributed to the public when the franchise in the area is terminated. The franchisor's interest in acquiring those telephone numbers is plainly legitimate and substantial. See, e.g., Sunward Elec., Inc. v. McDonald, 362 F.3d 17 (2d Cir. 2004). If a franchisor is in a business where retrieval of telephone numbers is important, transfer of those numbers should be expressly provided for as one of the franchisee’s post-termination obligations.

2. A Restriction On The Franchisee’s Indication Of Former Affiliation With The Franchise System

While a tag line on a sign or in a telephone listing reading “formerly the [insert your service mark] franchisee for this area” seems an obvious attempt to trade on the goodwill of the franchise system with the public, courts are often unwilling to consider it a form of trademark infringement because the message it conveys is literally true. If a franchisor wants to stop that kind of activity, an express prohibition in the franchisee’s post-termination obligations is desirable. While in many cases the franchisee can be prohibited from operating at all in its former territory under the franchise agreement’s noncompetition provision, a restriction on advertising a former affiliation with the franchise system can be very important with franchisees operating in states where their covenant against competition cannot be enforced.

3. An Obligation To Assign The Lease For The Franchised Location To The Franchisor Or Its Designee

If it is important to the franchisor to keep the formerly franchised location in the system after termination of a particular franchise agreement, the franchisor has several options. At least one major franchisor, as a matter of policy, owns all of the real estate from which franchisees operate and requires that the franchisee lease the premises from one of the franchisor’s affiliates. That approach has served that system very well. See Principe v. McDonald’s Corp., 631 F.2d 303 (4th Cir. 1980). A less expensive approach is to include in the franchise agreement an option of the franchisor to assume (and a corresponding obligation of
the franchisee to assign) the lease for the franchised location when the franchise agreement comes to an end. If that approach is taken, landlord approval will be required and should be reflected in the franchisee’s lease. If the franchisee owns the land on which the franchised business operated, the agreement might require the franchisee to lease the location to the franchisor following termination of the agreement.

II. ARBITRATION

The first question in drafting an arbitration provision for franchise disputes is whether the client wants an arbitration provision in its franchise agreement at all. Unlike a royalty provision, a covenant against competition or a termination provision, all of which a franchise agreement should contain, an arbitration provision is truly optional. The question is do you get enough benefit (principally in the form of avoidance of a jury)3 to make the cost (principally in the form of loss of a right of appeal) worthwhile. These are not, of course, the only potential benefits or liabilities of arbitration. See, e.g., Peter J. Klarfeld, The Trend Toward Arbitration Of Franchising And Trade Regulation Disputes, Of Interest 3 (A.B.A. Sec. Antitrust L. Oct. 1991) (comparing generally perceived advantages and disadvantages of arbitration and litigation).

In the past, the call has always been a fairly close one. However, it was made even more difficult by the uncertainty raised in the last few years as to how the state law doctrine of “unconscionability” (particularly as applied by the United States Court of Appeals for the Ninth Circuit) might be used to avoid or otherwise modify the terms of an agreement to arbitrate contained in a franchise agreement. Moreover, recent developments regarding the availability of class arbitration proceedings and the extent of punitive damages awardable in arbitration are also troubling. Even for those who previously viewed arbitration as a sensible vehicle for franchisors to use in resolving disputes with their franchisees (see, e.g., id.), this may be enough to tip the scales the other way.

If the choice is made to have an arbitration provision, bringing the experience and training of a trial lawyer into the process of drafting that provision can be particularly useful, since what you are doing is creating an alternate regime for litigation. Some of the issues on which a trial lawyer is likely to have views are the following.

A. Arbitrator Selection

One can argue about what is the most important aspect of an arbitration provision, but one serious contender has to be the mechanism for arbitrator selection. The talents of the person who ultimately resolves the dispute will have a pervasive effect on the perception of the parties as to the integrity of the process. A first-class arbitrator will conduct a proceeding in which the parties feel that their interests were taken seriously and appropriately considered, while a poor arbitrator will not generate that feeling no matter what the rules of the arbitration.

It is sometimes thought that one of the advantages of arbitration is the opportunity to obtain a decision-maker with industry expertise. In the franchise context, however, the franchise community is largely divided between people identified with franchisor or franchisee interests, and partisanship or the appearance of partisanship can be a genuine concern. Thus, ..............................

while industry expertise would be as useful in franchise arbitrations as in other industries, it may not always be available in a mutually acceptable neutral arbitrator.

Rather, what both parties may seek in a neutral arbitrator is fairness, legal sophistication, and competence in running a proceeding. Thus, it is in the franchisor’s interest to draft a provision that is likely to avoid a neutral arbitrator who instinctively sides with the smaller party or with the individual rather than the corporation. It is desirable for a franchisor to have a neutral arbitrator who is experienced and sophisticated in interpreting contract law. And it is desirable to have a neutral arbitrator who is experienced in making decisions and who has the ability to control an adjudicative proceeding, to recognize and weed out meritless arguments, and to move the proceeding toward a conclusion on the merits of the claims that remain.

Providing for that kind of arbitrator is not an easy thing to do. But the drafter can require in the arbitration provision that the neutral arbitrator have certain qualifications that are likely to lead to the competent handling of a franchise dispute. Many of the arbitration administration organizations keep lists of qualified contract arbitrators who can be readily designated as neutral arbitrators. For example, with JAMS/ENDISPUTE, the parties can be fairly certain to obtain a neutral arbitrator who has been a former state or federal judge if that is their desire. The American Arbitration Association maintains a national list of neutral arbitrators for complex litigation who are often trained in administering proceedings and who have a considerable degree of contractual experience and sophistication. The point is that this is a matter about which the drafter should worry and try to provide a method for arbitrator selection that is more likely to yield the type of neutral arbitrator that the client will trust. Unlike the random assignment of a judge in a case in court, the parties to an arbitration have an opportunity to have significant influence over who -- or at least what type of arbitrator -- they will draw.

One way to inject franchising expertise into the decision-making process, even if it will be difficult to find a neutral arbitrator with a franchising background acceptable to both parties, is to provide for a three-member arbitration panel with each party appointing one non-neutral arbitrator. While that arrangement will be more expensive, it allows each side to have some confidence that their selected neutral arbitrator will see through the silver-tongued arguments of the other side’s lawyer. If that approach is chosen, consider specifying that party-appointed arbitrators are allowed to have ex parte contact with the party that appointed him or her at least until the final decision conference. This gives both parties an opportunity to understand how the neutral arbitrator is viewing the case and to make any adjustments to their positions that they deem appropriate.

**B. Class Arbitration Proceedings**

In *Green Tree Financial Corp. v. Bazzle*, 539 U.S. 444 (2003), the Supreme Court held that in the absence of an express prohibition of class proceedings in the agreement to arbitrate, whether an arbitration should proceed as a class action should be decided by the arbitrator. Prior to that ruling, most federal courts had held that class proceedings were inappropriate where the agreement to arbitrate was silent on the subject. *See, e.g.*, *Champ v. Siegel Trading Co.*, 55 F.3d 269 (7th Cir. 1995).

Also in 2003, the American Arbitration Association issued Supplementary Rules for Class Arbitrations (http://www.adr.org). The AAA’s rules did not previously address class proceedings. Nonetheless, if a franchisor now has an agreement to arbitrate in its franchise agreement that is silent on class arbitrations, but says the arbitration will be conducted under
the AAA rules in effect at the time of the dispute, that franchisor will be deemed to have agreed to class arbitration. As of mid-April 2005, there were 64 class arbitrations being administered by the AAA.

The AAA class arbitration rules largely track Fed. R. Civ. P. 23, but in the less formal arbitration context and without a true right of appeal. Although an arbitrator’s decisions allowing class treatment and class certification can be challenged under the AAA rules in court, it is far from clear what standard will be applied in that review.

A strong argument can be made that the burdens and potential consequences of class proceedings and the intended informality and ad hoc decision-making process of arbitration simply do not mix well. Thus, a franchisor should strongly consider an express prohibition of class proceedings in any arbitration provision. If such a prohibition is included, it is likely that this issue will be treated as a “gateway” matter to be determined by a court. See, e.g., Gipson v. Cross Country Bank, 354 F. Supp. 2d 1278 (M.D. Ala. 2005); Discover Bank v. Superior Court, No. S113725, 2005 WL 1500866, at *15 (Cal. June 27, 2005). However, whether even an express waiver of class action proceedings in an arbitration provision will be enforced remains unclear. The California Supreme Court recently held that such a provision is “unconscionable” and therefore unenforceable in the consumer context. Discover Bank, at *11. While nothing in that opinion makes the case that the same result will or should be reached in the franchise context, the lack of certainty on this important issue is troubling.

Moreover, even if an express prohibition of class proceedings is included in an arbitration provision, AAA policy in this regard is less than fully satisfying. Rule 1 of the AAA’s Supplementary Rules for Class Arbitrations (Oct. 8, 2003) (available at http://www.adr.org/sp.asp?id=21936) states:

1. Applicability

(a) These Supplementary Rules for Class Arbitrations (“Supplementary Rules”) shall apply to any dispute arising out of an agreement that provides for arbitration pursuant to any of the rules of the American Arbitration Association (“AAA”) where a party submits a dispute to arbitration on behalf of or against a class or purported class, and shall supplement any other applicable AAA rules. These Supplementary Rules shall also apply whenever a court refers a matter pleaded as a class action to the AAA for administration, or when a party to a pending AAA arbitration asserts new claims on behalf of or against a class or purported class.

(b) Where inconsistencies exist between these Supplementary Rules and other AAA rules that apply to the dispute, these Supplementary Rules will govern. The arbitrator shall have the authority to resolve any inconsistency between any agreement of the parties and these Supplementary Rules, and in doing so shall endeavor to avoid any prejudice to the interests of absent members of a class or purported class.
Whenever a court has, by order, addressed and resolved any matter that would otherwise be decided by an arbitrator under these Supplementary Rules, the arbitrator shall follow the order of the court.

Paragraph 1(b) could be read to suggest that AAA arbitrators may be able to “resolve any inconsistency” between the AAA Rules that favor class arbitration and an agreement to arbitrate that expressly prohibits class arbitration in favor of class proceedings. If so, that might well be considered an unacceptable risk by franchisors.

Perhaps seeking to quell precisely that reaction, the AAA issued a “commentary” on its policy on class arbitrations on February 18, 2005, (available at www.adr.org/arbitrationpolicy) stating:

It has been the practice of the American Arbitration Association since its Supplementary Rules for Class Arbitrations were first enacted to require a party seeking to bring a class arbitration under an agreement that on its face prohibits class actions to first seek court guidance as to whether a class arbitration may be brought under such an agreement. The Association’s practice has been neither to commence administration of a case nor to refer such a matter to an arbitrator until a court decides that it is appropriate to do so. The Association’s determination not to administer class arbitrations where the underlying arbitration agreement explicitly precludes class procedures was made because the law on the enforceability of class action waivers was unsettled; the Association takes no position as to whether such clauses are or should be enforceable.

In a recent review of this practice by the Association’s Executive Committee it was agreed that this practice should be maintained in light of the continued unsettled state of the law. Courts in different states and different federal circuits have reached differing conclusions concerning the preclusion of class actions by agreement and “gateway” issues generally. However, the courts that have confronted the question have generally concluded that the decision as to whether an agreement that prohibits class actions is enforceable is one for the courts to make, not the arbitrator. In fidelity to its Due Process Protocols, the Association will continue to require all proceedings brought to it for administration to meet the standards of fairness and due process set forth in those protocols, but the Association will not seek to make decisions concerning class action agreements that the courts appear to have reserved for themselves.

While this offers some comfort, the AAA’s unwillingness to say that it will honor the parties’ express agreement to exclude class arbitrations outside of the consumer context --
despite the fact that voluntary agreement as to the terms of an arbitration is the only thing that
gives the arbitration any validity -- remains disturbing. It also raises the question of what other
express terms of an agreement to arbitrate the AAA is prepared to “resolve” away.

C. **Venue Selection**

The Federal Arbitration Act, 9 U.S.C. §§ 1 et seq., provides that an agreement to
arbitrate should be enforced according to its terms. Therefore, venue selection clauses
contained in arbitration provisions should be honored by both courts and arbitrators. However,
venue selection clauses have been involved in a number of recent cases suggesting that the
state law doctrine of “unconscionability” can be used to excise certain terms from agreements to
arbitrate. Nonetheless, there remains a strong reluctance, even in the Ninth Circuit, to
undermine terms that were agreed to. Compare *Laxmi Inv., LLC v. Golf USA*, 193 F.3d 1095
(9th Cir. 1999) (UFOC statement mandated by California regulation made agreement as to
venue uncertain) with *Bradley v. Harris Research, Inc.*, 275 F.3d 884 (9th Cir. 2001) (California
statute prohibiting selection of venue for arbitration outside California held pre-empted by the
Federal Arbitration Act). For example, it appears that *Ticknor v. Choice Hotels International,
Inc.*, 265 F.3d 931 (9th Cir. 2001) and *Bolter v. Superior Court*, 87 Cal. App. 4th 900, 104 Cal.
Rptr.2d 888 (2001), both of which refused to enforce venue selection clauses in arbitration
agreements based on unconscionability, are both in the process of being limited to their facts (a
“mom-n-pop” operation, the renewal agreement context). In *Nagrampa v. Mailcoup Inc.*, 401
F.3d 1024, (9th Cir. 2005), reh'g en banc granted, 2005 WL 1515082 (9th Cir. June 28, 2005), a
panel of the Ninth Circuit held that *Ticknor* should not have reached the issue of whether the
whole agreement before it was a contract of adhesion because, once an arbitration clause is
found valid, the arbitrator rather than a court should decide claims regarding adhesion. The
Ninth Circuit panel went on to affirm the district court decision finding venue selection in Boston
was not “unconscionable” and distinguishing *Bolter*. See also *In re Mercurio*, 402 F.3d 62 (1st
Cir. 2005) (upholding a venue selection clause in an arbitration provision).

A convenient venue for arbitration can have both psychological and practical importance.
Despite the attacks on them in recent years, a venue selection clause should be considered by
franchisors an important part of the drafting of an agreement to arbitrate.

D. **A Carve-Out For Actions To Obtain Preliminary Injunctive Relief From A Court**

When certain types of franchise relationship disputes arise, the franchisor needs
immediate injunctive relief to avoid irreparable harm. For example, when a present or former
franchisee is breaching his or her agreement not to compete with the franchise system, or is
infringing the system’s service marks or misappropriating its confidential information, the first
order of business is to stop the bleeding. While an arbitrator could theoretically issue a
preliminary directive that the conduct cease, no arbitrator has been selected when the
proceeding is commenced and the mechanisms for getting a suitable arbitrator in place and
ready to make that kind of decision are cumbersome. If its franchise agreement contains a
blanket arbitration provision, however, the franchisor’s application to a court for immediate relief
is likely to be met by a motion from the franchisee to stay the court action pending arbitration.

Without guidance in the arbitration agreement, courts are divided on whether they can
enter preliminary injunctive relief (which would involve a decision on the likelihood of success of
the franchisor on the merits of its claim) or must defer to the parties’ agreement to arbitrate all
issues. However, express carve-outs contained in the language of arbitration provisions
authorizing applications for judicial equitable relief are not uncommon in franchise agreements and are likely to be honored. See, e.g., Peabody Coalsales Co. v. Tampa Elec. Co., 36 F.3d 46, 48 (8th Cir. 1994) (reversing a denial of preliminary injunctive relief pending resolution of the underlying dispute in arbitration because such relief was “in accordance with the terms of the agreement” between the parties); Manion v. Nagin, 255 F.3d 535, 539 (8th Cir. 2001) (same). In addition, Rule R-34(c) of the Commercial Dispute Resolution Procedures of the American Arbitration Association (July 1, 2003) (available at http://www.adr.org/sp.asp?id=22002) provides:

A request for interim measures addressed by a party to a judicial authority shall not be deemed incompatible with the agreement to arbitrate or a waiver of the right to arbitrate.

In short, although it may be possible to sustain an application to a court for equitable relief even in the absence of an express carve-out in the language of the arbitration provision, there is no question that a carve-out is desirable.4

E. Exclusion Of Punitive Damages Awards

A waiver in an arbitration provision of punitive or exemplary damages expressly provided for under a federal statute (e.g., the Clayton Act, 15 U.S.C. § 15(a)) is probably unenforceable. See Booker v. Robert Half International, Inc., __ F.3d __, 2005 WL 1540796 (D.C. Cir. July 1, 2005) (severing punitive damages exclusion from arbitration provision governing claim under the District of Columbia Human Rights Act and compelling arbitration). However, a provision limiting the monetary relief that the arbitrator can award in other circumstances to actual compensatory damages should be seriously considered.

First, such provisions are widely recognized and enforced in the commercial arbitration context. Second, part of the attraction of commercial arbitration is its promise of a practical, informed and dispassionate resolution of business disputes, and removal of the wild card of punitive damages is consistent with that objective.

Third, a recent case decided by the Connecticut Supreme Court holds that if punitive damages are awarded in an arbitration, the restraints on excessive awards that have been developed in the litigation context may be found not to apply. In MedValUSA Health Programs, Inc. v. Memberworks, Inc., 273 Conn. 634, 640-41, 872 A.2d 423, 428 (2005), the court stated (footnote omitted):

The defendant claims that the trial court improperly confirmed the arbitrator’s award because the award of punitive damages was excessive: (1) in violation of the defendant’s right to due process

4 Some arbitration administration organizations have adopted rules designed to allow parties to obtain an emergency interim order from an arbitrator to avoid irreparable harm. See, e.g., American Arbitration Association Optional Rules For Emergency Measures Of Protection (July 1, 2003) (available at http://www.adr.org/sp.asp?id=22002). Such rules also could be adopted in a franchise agreement arbitration provision, but their mechanisms for arbitrator selection, presentation of the issues, and enforcement do not at this stage inspire the same confidence as a preliminary injunction proceeding in a federal court.
under the fourteenth amendment of the United States constitution; and (2) in violation of well-defined Connecticut public policy. We disagree. We conclude that, because an arbitration award does not constitute state action and is not converted into state action by the trial court’s confirmation of that award, an arbitration panel’s award of punitive damages does not implicate the due process clause, regardless of how excessive the award may be. Furthermore, we conclude that, because Connecticut does not have a well-defined public policy against the award of excessive punitive damages, the award does not violate public policy.

See also Hadelman v. Deluca, Bus. Franchise Guide (CCH) ¶ 13, 102 (Conn. July 12, 2005) (same in the context of an arbitration award of punitive damages against the SUBWAY sandwich shop franchisor).

In response to the dissent’s argument that if that rule were adopted, no one would enter an arbitration agreement, the majority in MedValUSA responded that it was more likely that people would continue to agree to arbitrate but would specifically include limits on punitive damages in their arbitration agreements. Id. at 656 n.14, 872 A.3d at 437 n.14. If a franchisor chooses to include an arbitration provision in its franchise agreements, it is well advised to consider including a specific prohibition on punitive damages in the provision.

F. Provision For Reasonable Discovery

In general, there is a presumption in arbitration against the wide-open discovery that characterizes the Federal Rules of Civil Procedure. For example, the Commercial Arbitration Rules of the American Arbitration Association do not provide for depositions at all. Nonetheless, some discovery is likely to be necessary for an informed result and to avoid trial by ambush. Therefore, it is desirable to include a provision making clear to the arbitrator that his or her allowing reasonable, tailored discovery (including depositions) -- given the claims and the circumstances of the case -- is both authorized and expected.

G. Motions Practice

In a large percentage of the franchise cases that are brought to arbitration, the underlying facts are not subject to genuine dispute, and there is no real need for the inconvenience and expense of an evidentiary hearing to establish those facts. While standard arbitration rules may be read to give the arbitrator the authority to allow motions for summary judgment, they are sometimes less than crystal clear on the point (see, e.g., Rule R-32(b) of the AAA Commercial Arbitration Rules, available at http://www.adr.org/sp.asp?id=22002). If motions practice is considered desirable -- and for most franchisors in most situations it should be -- it should be specifically provided for in the arbitration provision.

III. ADVERTISING FUNDS

A. Strategic Considerations

By “fund” we mean money contributed by the franchisee that can be spent by the franchisor or at the franchisor’s direction for advertising and marketing programs. These typically include a “national” or “system” fund, usually administered by the franchisor, to which
all franchisees (and perhaps company-owned units as well) contribute; and regional and/or local cooperative funds ("co-ops"), supported by units in particular markets and administered under the franchisor’s supervision. Because the franchisee contributes money but does not control its disposition, the most common claim is that the money in the fund was spent improperly. In responding to such a claim, the franchisor is confronted at the outset by a problem of nomenclature. The term “fund," widely used in franchise agreements for decades, connotes a discrete, dedicated amount or account; the franchisor generally controls its use; and it is a short step for a franchisee to argue that the money in the “fund” is the franchisees’ money, that the franchisor has assumed obligations akin to fiduciary duties in administering the fund, and that improper administration gives rise not only to claims of breach of contract but to claims of breach of fiduciary duties and exposes the franchisor to the remedies – including punitive damages – available for such claims. See generally, Broussard v. Meineke Discount Muffler Shops, Inc., 155 F.3d 331 (4th Cir. 1998). While the franchisor in Broussard was ultimately able to deflect the fiduciary duty claims, the case offers some insight into how drafting might make resolution of the issue considerably easier.

Two approaches suggest themselves. The draftsman might consider dispensing with the concept of a “fund” altogether, and instead (a) folding ad fees into, for example, the royalty payment (the franchisor’s money) and (b) obligating the franchisor to spend a certain amount of “its” money in certain ways. If the franchisor fails to do so, the consequence should be a claim for breach of contract, nothing more. This may not be the perfect solution, however. Increasing the royalty may make it harder to market the franchise offering, if only for psychological reasons. Also, there can be no assurance that this approach would not be argued to be cosmetic, or a subterfuge.

The second option of the draftsman is to recognize the overtones which may accompany the term “fund” and to provide in the franchise agreement standards for administering the fund that are consistent with the franchisor’s need for flexibility and authority and that disclaim not only fiduciary duties but any responsibility broader than (implied) good faith. Indeed, two benefits could accrue from including detailed provisions regarding the fund and its administration. First, it increases the likelihood that the franchisor’s actions will be found to be authorized, thereby reducing its exposure. Second, detailed provisions increase the prospect that courts would treat claims that do arise as contract claims rather than tort claims.

B. Principal Areas to Consider

The issues arising from ad funds fall into four categories, each presenting its own drafting challenges. One might call them the “four Ps”: process, purposes, profitability, and proof.

1. Process

This presents a number of sub-issues for the draftsman to consider and perhaps address, including the following:

a. How much money must the franchisee contribute; may the franchisor increase that amount; is the decision to do so subject to a standard other than the franchisor’s business judgment, or indeed to any standard at all;
b. Whether the franchisor may from time to time allocate the franchisee’s contribution among national, regional and local funds;

c. Whether franchisor units will contribute, and, if so, will they do so on the same basis as franchisees;

d. Whether the franchisor may specify the particular co-ops to which the franchisee must belong;

e. In what form is the fund or co-op to be organized; how to insure that it can function effectively in the face of disagreement among its members; who has custody of the co-op’s money; are franchisee payments made to the franchisor or to the fund; who may/must pursue non-contributing franchisees;

f. May a fund or co-op be disbanded and then reconstituted; if disbanded, what happens to unspent money.

2. Purposes

This deals with the uses to which the fund may be put. The objective is to confer the broadest authority to encompass all anticipated uses. This could include, for example, the planning and production of ad campaigns and materials; media placement; administrative aspects; brand promotion; product development; concept development; etc. Special care should be taken in the contract to authorize use of the funds in paying the franchisor and its affiliates for services they are expected to render, and for such uses as advertising for sales of franchises rather than advertising to consumers of the business’ products or services.

3. Profitability

This subject presents the draftsman with two distinct but related matters to consider. First, by their very nature, advertising and marketing campaigns are not assured of “success,” however that may be measured. The franchise agreement should contain a disclaimer to that effect.

Second, funds may not always be deployed in each franchisee’s market area in proportion to its contribution. For example, the franchisor may conclude that funds should be concentrated (if only temporarily) in markets in which the system faces especially intense competition, or to overcome unfavorable local publicity, or to support a newly-opened market. The franchise agreement should clearly afford the franchisor sufficient latitude in this respect, and should disclaim any franchisee entitlement to pro rata allocation or benefit.

4. Proof Of Proper Use

Finally, the franchisor should be prepared to demonstrate that it handled advertising funds properly. The challenge falls broadly under two headings.

The first is being prepared to document how money was spent. The most sensitive area involves payments from the fund to the franchisor or its affiliates. Even when the franchise agreement authorizes such payments, that is not the end of the matter. For example, if X% of
the salary of a franchisor’s employee is going to be paid by the fund, the franchisor should be prepared to show why that was an appropriate allocation.

Second, the draftsman should consider providing in the franchise agreement for disclosure to the franchisee of how the fund was used by the franchisor, either periodically or upon request. Disclosure promotes several desirable objectives. First, it is likely to promote franchisee trust and reduce franchisee suspicion. Second, disclosure not only is likely to trigger the running of the statute of limitations, but also makes it harder for a franchisee later on to challenge persuasively expenditures that were disclosed without challenge some time before. Third, proper disclosure is likely to be viewed favorably by courts and juries, while non-disclosure could be seen by them as concealment. Finally, the prospect of disclosure should promote greater prudence by the franchisor in its administration of advertising funds.

IV. COVENANTS AGAINST COMPETITION

The drafting of covenants against competition presents all of the difficulties of drafting any other provision of a franchise agreement, plus one very large additional hurdle. With most provisions, the goal is to decide what the client wants to accomplish, to anticipate mechanical and operational issues, and to embody that objective in language that leaves no room for misunderstanding. Generally, the law does not inquire into whether a contractual commitment between commercial parties is reasonable or unreasonable, only whether it was agreed to. However, because covenants against competition restrict a franchisee’s ability to engage in the business of his or her choice, the law of most states subjects them to a rule of reasonableness. See generally Peter J. Klarfeld, Covenants Against Competition In Franchise Agreements (A.B.A. 2d ed. 1992).5

So in drafting covenants against competition, the draftsman must ask not only is it complete and is it clear, but is it defensible. In other words, will the duration, the territory covered and the activity restricted by the covenant be deemed “reasonable” given the nature of the franchise involved? Moreover, not only will a covenant against competition -- like any other provision -- be interpreted against its drafter if an ambiguity cannot be resolved otherwise, it will also be interpreted against restriction of competition, putting an added premium on precision in this context.

In addition, this “reasonableness” requirement is a function of state law, and its application therefore varies from state to state. See id. Moreover, a choice of law provision will not always be enforced in this context, with courts sometimes yielding to the “public policy” regarding covenants against competition of the state where the franchised unit is located. Finally, this provision will often become operative after the franchise relationship has ended and any goodwill or spirit of cooperation between the parties has come to an end.

For all of these reasons, there is an unusually long list of considerations in connection with the drafting of franchise covenants against competition. They include the following:

5 Under the law of some states, enforcement of post-termination covenants against competition is precluded in most franchise arrangements by statute. See, e.g., N.D. Cent. Code § 9-08-06 (West 2003) (voiding any covenant against competition other than those arising in the context of the sale of a business or the dissolution of a partnership).
A. The Use Of Acknowledgements

Because the “reasonableness” of a covenant against competition will be a function of what is necessary to protect the franchisor’s legitimate interests, there is a special need here to make those legitimate interests accessible to the court or jury. Thus, express articulation and franchisee acceptance of those interests, their bases and the relationship of those interests to the restrictions imposed can be helpful. The most direct route is express franchisee acknowledgements which might include the following:

a. That the franchisee will, during the franchise relationship, become identified with the goodwill associated with the franchisor’s trademarks and service marks.

b. That the franchisee, during the franchise relationship, will receive confidential information from the franchisor with respect to the operation of the franchise system generally and the franchisee’s business in particular. In this regard, it is important to bear in mind that the confidential information conveyed by a franchisor is ordinarily much broader than the specific recipes for food products or the procedures for quick lubrication of an automobile. In most franchise systems, operations know-how (not how to do taxes but how to run a tax business; market research; the workings of purchasing programs) is at least as important, and the franchisee’s acknowledgement should capture the breadth of confidential information involved.

c. That the franchisee may be exposed not only to the business operations of the franchisor but to those of other franchisees as well, the point being that free communication among franchisees may be chilled if it is perceived that a fellow franchisee has a conflict of interest.

d. That the restrictions imposed by the covenant will not unreasonably limit the franchisee’s business opportunities.

e. With respect to quick service restaurant concepts, that the effective competition is broader than the particular food products offered in this franchisor’s system (e.g., hamburgers) and extends to all fast food.

f. That damages are not an adequate remedy for breach of the covenant and that the franchisee consents to the entry of a preliminary injunction if the court finds a likelihood of breach. If a court is instinctively reluctant to grant preliminary relief that will put a former franchisee out of business, it will sometimes say that damages at the end of the case will be an adequate remedy. A contractual acknowledgment by the franchisee that that is not the case can help avoid that outcome.

g. If the covenant prohibits not just competition but also the sale or lease of property to a competitor, that the location of the franchised unit itself becomes associated with the franchisor’s marks.

B. Time Restrictions

1. Duration

Generally, the reasonableness of the duration of a post-termination covenant against competition in the franchise setting is measured by the time it would take for the franchisor to
redevelop the territory and for the value of the confidential information that has been conveyed to the former franchisee to dissipate. Any restriction lasting more than two years following termination or expiration of the franchise agreement would benefit from an internal acknowledgement of the reason why the longer period is necessary (e.g., unusually slow dissipation of the usefulness of particular types of confidential information; limited customer contact opportunities, as would be the case in a service franchise where there is meaningful contact with the customer only once or twice a year).

2. Extension Of The Duration To Account For Periods Of Noncompliance

Given the relatively brief period that a post-termination covenant would ordinarily be deemed reasonable, a significant portion of that time could be taken up in obtaining injunctive relief. In fact, if preliminary relief is denied and an appeal is necessary to enforce the covenant, the entire restriction could expire before the franchisor is able to obtain an injunction. Therefore, language providing for an extension of the covenant for any period of noncompliance could make the difference between having full injunctive relief and no injunctive relief at all. An argument can be made for extending the duration of a covenant as a matter of equity during the time necessary to enforce compliance even in the absence of an express provision. However, the courts are split on the issue. Compare, e.g., Thermatool Corp. v. Borzym, 227 Mich. App. 366, 375, 575 N.W.2d 334, 338 (1998) (extending duration as a matter of equity); Advanced Marine Enterpr., Inc. v. PRC Inc., 256 Va. 106, 119, 501 S.E.2d 148, 156 (1998) (same); with A.E.P. Indus., Inc. v. McClure, 308 N.C. 398, 302 S.E.2d 754 (1983) (refusing to extend a covenant against competition that had expired during the covenantee’s attempt to obtain enforcement). Therefore, an express provision extending the duration of the covenant to make up for any period of noncompliance could make litigation of the issue a lot easier.

C. Distance Restrictions

1. In-Term Restrictions

The franchisor’s legitimate interests in restricting competition by the franchisee with the franchisor and other members of the franchise system are considerably stronger during the term of a franchise agreement than after termination of the agreement. For example, while the agreement is in effect, the franchisee is receiving ongoing use of the system and an active pipeline of updated information (including methods and procedures, market research, advertising and marketing strategy, new product development, training and other assistance). Wherever the franchisee uses that information and know-how without paying royalties, the franchisor is being deprived of compensation for a substantial component of what it is selling under the agreement. Moreover, if that competing restaurant is near the franchisee’s own franchised unit, the franchisee could divert customers to his non-system, non-royalty-paying unit, and if that competing unit is near another franchisee in the system, that franchisee will find the know-how and other confidential information it is paying to receive being used against it by a competitor. Moreover, during the term of the franchise agreement, the franchisee is not being deprived of an opportunity to engage in the business of his or her choice; the franchise

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6 In one case, a federal trial court in North Carolina ordered that a franchise covenant against competition begin to run from the date of enforcement rather than the date of termination. Baskin Robbins, Inc. v. Golde, No. 5:99-CV-102-BR(3) (E.D.N.C. May 26, 2000). Nonetheless, the weight of North Carolina authority is to the contrary.
agreement provides the franchisee with exactly that opportunity. As a result, in-term covenants against competition are given broad deference, and geographically unlimited in-term covenants are likely to be found reasonable under the law of most states. See, e.g., Deutchland Enters. v. Burger King Corp., 957 F.2d 449 (7th Cir. 1992). Even some states that statutorily restrict covenants against competition in the franchise context following termination of the franchise agreement allow enforcement of in-term covenants against competition. See, e.g., Dayton Time Lock Serv., Inc. v. Silent Watchman Corp., 52 Cal. App. 3d 1, 124 Cal. Rptr. 678 (1975). Thus, use of a geographically unlimited in-term covenant should be considered unless applicable state law has specifically rejected the concept.

2. Post-Term Restrictions

Geographically unlimited post-termination covenants against competition in the franchise context are almost invariably held to be unreasonable and unenforceable. However, prohibitions on former franchisees from competing not only within their own formerly franchised territory but within a reasonable radius of other members of the franchise system (company-owned and franchised units alike) have been enforced by many courts. See, e.g., Armstrong v. Taco Time Int'l Inc., 30 Wash. App. 538, 635 P.2d 1114 (1981); Casey’s Gen. Stores, Inc. v. Campbell Oil Co., 441 N.W.2d 758 (Iowa 1989) (applying Iowa common law). Thus, if a franchisor is going to want to stop former franchisees from competing directly with other members of the franchise system, the franchisor should consider including this “remote area protection” expressly in its post-termination covenant.

D. Activities Restrictions

1. Restriction Of The Sale Of The Franchised Location To A Competitor

In addition to the usual list of activities restricted by a covenant against competition in the franchise context (e.g., operating, owning, being employed by, or providing assistance to any similar business), franchisors also often protest when former franchisees sell or lease the land and building of the formerly franchised unit to a competitor. If the client is going to want to try to stop that transfer of the formerly franchised location, then it should draft accordingly. While this type of prohibition might be considered pushing the envelope, at least in those situations where the customer comes to the franchised unit (e.g., a restaurant, a quick lube location, a tax services office) rather than the franchisee going to the customer an argument can be made that the franchise system’s goodwill attaches to the location, at least for a period of time. The argument for restricting sale to a competitor is even stronger where the franchisor has provided for and is prepared to exercise a right of first refusal or at least is attempting to find a buyer who will keep that location in the franchise system.

2. The Problem Of Articulating What Is Competitive

A second area in which franchisors often wish to restrict former franchisees’ activities but do not always draft accordingly is operation of a business that competes with the formerly franchised business even though the menu or products offered by the new business are somewhat different from those that were offered by the formerly franchised business. While it is tempting simply to prohibit “competition” with the franchise system following termination, problems can arise where the former franchisee was the only representative of the franchise system in a particular territory. Thus, the franchisee argues that if he continues in the same business at the same location, he is not “competing” with the franchisor because the franchisor has no other system units in that territory.
One way drafters of franchise agreements have sometimes attempted to deal with this problem, as well as to make their covenants narrower and therefore more likely to be enforced, is to prohibit the franchisee from engaging in “the same or a similar business.” However, the question then becomes what is a “similar” business. Is it a business using the same business format, or selling the same products, or both, or something else? On the other hand, an attempt to define competition as a business that offers a product that makes up a certain percentage of the sales of a franchise system’s restaurants can be both over- and under-inclusive in terms of effective competition depending on the circumstances. In the end, each industry and franchise system may be somewhat different, and the best advice is to consider fully what type of conduct the client wants to prohibit and why. If, for example, the client will be unhappy if the former franchisee enters into any other quick service restaurant business, consider whether there is a legitimate basis (for example, as a result of market research conveyed to franchisees, confidential information regarding operation of a quick service restaurant generally, or upcoming advertising campaigns) that would make the imposition of that type of restriction “reasonable,” and if there is, impose that restriction expressly rather than trying to extract it later from language that is too narrow to do the job.7

E. People Restricted

All franchise covenants against competition are drafted to restrict the competitive conduct of the franchisee. The question is who else will it later turn out that the franchisor needed to restrict. Often the covenant recites that neither the franchisee nor its owners or principals may engage in the restricted conduct. That’s a good start, as long as the owners or principals are required to sign the franchise agreement in an individual capacity or to enter into a separate agreement to be bound personally. Without their personal agreement to the restriction, enforcement against them, while not always impossible, can be very difficult.

Does the franchisor also want to reach executives and managers of the franchisee company, particularly those who received training from the franchisor? Are there particular family members who it may be desirable to bind if they become active in the business? If so, it may be useful to have an option built into the covenant against competition to require the franchisee to deliver individual covenants from those people upon the franchisor’s request.

In some businesses, the franchisor’s goodwill may become associated not only with the franchisee but with the franchisee’s employees who provide customer service directly. For example, individual tax preparers in a tax preparation business or other individual service personnel may develop relationships with customers that are as strong as or stronger than those of the franchisee itself. In those situations, it may be desirable for the franchisor to require the franchisee to obtain covenants against competition from those particular employees.

On the other hand, if the law of a state that is important to the franchise system is perceived as generally restrictive with respect to post-termination covenants against competition, a narrow activities restriction may allow the franchisor to make the strongest possible argument for enforcement. See, e.g., Great Harvest Franchising v. McKinley, Bus. Franchise Guide (CCH) ¶ 11,260 (C.D. Cal. June 26, 1997) (franchisor allowed to pursue a claim for breach of a post-termination covenant prohibiting the former franchisee from selling wholewheat bread despite the voiding of post-termination covenants against competition “by which anyone is restrained from engaging in a lawful profession, trade or business” in Cal. Bus. & Prof. Code §§ 16600 et seq.); Great Harvest Franchise v. Artim, Bus. Franchise Guide (CCH) ¶ 11,259 (E.D. Cal. June 23, 1997) (same).
identifying the franchisor as a third party beneficiary for purposes of enforcement. If so, the covenant should prohibit competition with the franchisor, the franchise system, and the franchisee acting as a member of the franchise system, rather than just the franchisee itself. The reason is so that franchisee employees will not be prohibited from joining the franchisor or other franchisees if the franchisee that was the original employer should be terminated or choose to leave the system.

Finally, it is important to make sure that people leaving the franchisee organization or the franchisee following an approved transfer of the franchise business are bound by post-termination covenants against competition, even though the franchise agreement has not been terminated. That is usually what was intended, and drafting for it expressly makes its realization much more certain.

F. Designation Of The Covenant As An Independent Obligation

When a franchisor seeks to enforce a post-termination covenant against competition, it is not uncommon for the former franchisee to argue that the franchisor materially breached the franchise agreement first, and that therefore the former franchisee should be relieved of its obligations under the post-termination covenant. At the end of the day, the premise may well turn out not to be true. However, at the preliminary injunction stage that argument can be enough to give a court pause as far as entering an order shutting down a former franchisee's business. A provision in the covenant stating that the franchisee’s obligation to comply with the covenant is independent of whether the franchisor has performed with respect to other aspects of the franchise agreement can help to get over that hurdle.

G. The “Georgia” Issue

State court decisions regarding what is reasonable with respect to restriction of competition by franchisees or former franchisees can vary according to the law and precedent of different states. For the most part, however, what is reasonable in one state can at least be argued to be reasonable in another (assuming, of course, that a state statute does not prohibit the enforcement of franchise covenants altogether). However, of those states that allow enforcement of covenants against competition in the franchise context at all, probably none is more inhospitable to enforcement than the law of the state of Georgia. For example, with respect to issues such as in-term competition, remote location protection, tolling of the duration of the covenant during enforcement, and many other aspects of covenant enforcement, Georgia law will not only find aspects of normal franchise covenants to be overbroad, vague or otherwise unenforceable, it will also void the entire covenant in which such a provision appears. See, e.g., Dent Wizard Int'l Corp. v. Brown, 272 Ga. App. 553, 612 S.E.2d 873 (2005). Moreover, Georgia public policy in this area is so strong (its roots are traceable to the Georgia Constitution) that no choice of law provision designating a law other than that of Georgia is likely to be found enforceable with respect to a franchise unit located in Georgia. In short, while it is possible to draft a covenant against competition in a franchise agreement that would be enforceable in Georgia, it would have to be so narrow as to deprive the franchisor of protection of a number of legitimate interests that would be allowed in most other states. Therefore, if a franchisor anticipates having significant franchising activity in Georgia, it would make sense to use a separate amendment to the franchise agreement with respect to those units so that at least some protection could be obtained.
V. FORUM SELECTION CLAUSES

A. Forum Selection Clauses Are Generally Enforceable

Forum selection clauses are presumptively valid and routinely enforced if they are reasonable “under the circumstances.” Such clauses are considered unreasonable (1) if they were included in the agreement as a result of fraud or overreaching; (2) if the complaining party “will for all practical purposes be deprived of his day in court” because of the grave inconvenience or unfairness of the selected forum; or (3) the clauses contravene a strong public policy of the forum state. The mere fact that franchise agreements are form contracts offered to the franchisee on a “take it or leave it” basis does not, by itself, render forum selection clauses unenforceable. A forum selection clause will be enforced even if franchise agreement as a whole was fraudulently induced unless the clause itself was the result of fraud or coercion. An enforceable forum selection clause is not, however, dispositive on a motion to transfer under 28 U.S.C. § 1404(a). It is merely one of several factors a court must consider on an individualized, case-by-case consideration of convenience and fairness.

1. Recite Basis For Reasonableness Of Forum Selection Clause

The party who objects to a forum selection clause has the burden of showing that it is unreasonable. Although that burden may be heavy, it can be made more difficult if the agreement recites the reasons why the selected forum is appropriate. Moreover, because an enforceable forum selection clause does not preclude a motion to transfer on the basis of forum non conveniens, the franchise agreement should waive the right to move for a transfer. Consider the following example of such a clause:

**Forum Selection Clause – Example 1**

“Because the State of New York has a well developed history of business decisional law and because the courts of the State of New York are best suited to interpret and apply that law, we each agree that any litigation arising out of or related to this Agreement . . . will be submitted to and

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8 Bremen v. Zapata Offshore Co., 407 U.S. 1, 10 (1972); Jones v. GNC Franchising, Inc., 211 F.3d 495, 497 (9th Cir. 2000).

9 Id. at 12-13, 15, 18; Carnival Cruise Lines, Inc. v. Shute, 499 U.S. 585, 594-95 (1991); Argueta v. Banco Mexicano, S.A., 87 F.3d 320, 325 (9th Cir. 1996).


11 Batchelder v. Kawamoto, 147 F.3d 915, 919 (9th Cir. 1998).


resolved exclusively by a court of competent jurisdiction located in the City and State of New York. You waive, and agree never to assert, move or otherwise claim that this venue is for any reason improper, inconvenient, prejudicial or otherwise inappropriate (including, any claim under the judicial doctrine of forum non conveniens).

2. **Mandatory/Permissive Forum Selection Clauses**

One concern in drafting an enforceable forum selection clause where unreasonableness is not an issue, is making certain the clause is mandatory and not permissive. “Mandatory forum selection clauses contain clear language showing that jurisdiction is appropriate only in the designated forum. In contrast, permissive forum selection clauses authorize jurisdiction in a designated forum, but do not prohibit litigation elsewhere.”\(^{14}\) Ambiguous clauses are construed against the drafter as permissive.\(^{15}\) The following forum selection clause is permissive: “The courts of California, County of Orange, shall have jurisdiction over the parties in any action at law relating to the subject matter or the interpretation of this contract.”\(^{16}\) In contrast, the following forum selection clause is mandatory: “Licensee hereby agrees and consents to the jurisdiction of the courts of the State of Virginia. Venue of any action brought hereunder shall be deemed to be in Gloucester County, Virginia.”\(^{17}\)

The following examples of forum selection clauses from current franchise agreements illustrate how a simple mandatory forum selection clause can be drafted:

**Forum Selection Clause - Example 2**

“Franchisee and Franchisor agree that any action arising out of or relating to this Agreement (including the offer or sale of the Franchise) shall be instituted and maintained only in a state or federal court of general jurisdiction in Waukesha County, Wisconsin, and Franchisee irrevocably submits to the jurisdiction of that court and waives any objection he may have to either the jurisdiction or venue of court.”

**Forum Selection Clause - Example 3**

“Both parties agree that unless superseded by governing state statutes, all litigation shall take place in the Courts of Marin County, California.”

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17. *Docksider, Ltd. V. Sea Tech., Ltd.*, 875 F.2d 762, 763 (9th Cir. 1989).
The following example of a forum selection clause from a current franchise agreement illustrates an ambiguous clause which will likely be deemed to be permissive:

**Forum Selection Clause - Example 4**

“In the event either party initiates any litigation or lawsuit under this Agreement, or relating in any way to the relationship of the parties as Franchisor and Franchisee, that party agrees that venue properly lies in the courts of the state where the other party then has its principal place of business (presently ____________ in the case where franchisor is defendant) or the territory is located (in the case where Licensee is defendant), and will file such litigation or lawsuit only in such court.”

Example 4 appears, at first glance, to require the franchisor to bring an action against the franchisee where the franchisee is located and the franchisee to bring an action against the franchisor where the franchisor is located. But, the clause does not mandate doing so. When the clause is simplified, it reads: “In the event either party initiates any litigation . . . that party will file such litigation . . . only in such court.” But which court is “such court?” The clause provides that both parties agree that venue is proper where the franchisor is located and also proper where the franchisee is located. “Such court” could be construed as either where the franchisor or the franchisee is located when the lawsuit is filed.

3. **Scope Of Claims Subject To Forum Selection Clause**

Another concern in drafting an enforceable forum selection clause is setting forth the scope of the claims which may come within the clause. In Example 3 above, the parties agreed that “all litigation shall take place in . . . .” But it is not clear what “all litigation means.” Does it mean literally any litigation instituted between the parties or could it mean all litigation relating to the construction or enforcement of the franchise agreement? Because an ambiguous forum selection clause is construed against the franchisor, as the drafter, this clause could be construed as permissive to any litigation other than litigation over the construction or enforcement of the franchise agreement.

4. **Injunctive Relief And Real Property Actions**

Most franchise agreements require that litigation and arbitration proceedings be brought in the city or county where the franchisor has its principal place of business. Such a clause could present a problem to the franchisor in need of injunctive relief or seeking real property if it required “all litigation” be brought in the place where the franchisor has its principal place of business, as in Example 3.

A court cannot directly enjoin a person it does not have personal jurisdiction over.\(^{18}\) Although such a person can be enjoined from “aiding and abetting” a party’s violation of an injunction, that person could violate the injunction without aiding and abetting the enjoined party. For example, suppose a Nevada based franchisee who is subject to a post-termination

covenant not to compete closes his business at the end of the franchise term and sells all of his assets to a third party who continues the franchisee’s business in the same location. If the franchisor believes the asset sale is a violation of the covenant not to compete, the franchisor may seek an injunction against both the franchisee and the person who purchased the franchisee’s assets. However, if the franchisor is located in Wisconsin and the franchise agreement has the forum selection clause set forth in Example 3, then the franchisor would have to bring two separate actions for injunctive relief. One would be brought against the franchisee in Wisconsin, and the other would be brought against the third-party purchaser in Nevada.\(^{19}\)

Similarly, a franchisor may not be able to obtain summary relief with respect to real property except from a court which can assert jurisdiction over real property.

The following is an example of a forum selection clause which adequately carves out bringing an action for injunctive relief outside of the selected forum:

**Forum Selection Clause – Example 5**

“...shall be resolved by a proceeding in a court in Dallas County, Texas, ...; provided, however, with respect to any action which includes injunctive relief, or any action for the recovery of any property, real or personal, XYZ may bring such action in any state which has jurisdiction.”

5. **State And/Or Federal Forum**

A franchisor should consider whether claims may be brought in state and federal court or just state court. Most forum selection clauses clearly state whether an action may be brought in a state and/or federal court. Example 2 clearly states that an action may be brought in either state or federal court:

“...shall be instituted and maintained only in a state or federal court of general jurisdiction in Waukesha County, Wisconsin, ...”

On the other hand, Example 3, is ambiguous:

“Both parties agree that unless superseded by governing state statutes, all litigation shall take place in the Courts of Marin County, California.”

The “Courts of Marin County” could refer only to the California Superior Court in and for the County of Marin, or could also refer to the United States District Court for the North District of California which is located in San Francisco County, but encompasses Marin County.

\(^{19}\) *Herrlein v. Kanakis*, 526 F.2d 252, 254 (7th Cir. 1975)(defendants were enjoined from selling pet food products; nonparty, who had purchased assets from defendants before suit was brought, could not be held liable, even though it sold the enjoined products, because defendants were not held liable for violating injunction; this was true even though one of defendants was new manager of non-party).
The following forum selection clause is another example of an ambiguous clause which does not clearly designate the court which must be used:

**Forum Selection Clause – Example 6**

“. . . you and your Owners agree that all judicial actions brought by us against you or your Owners or by you or your Owners against us or our Affiliates, or our or their shareholders, officers, directors, agents, or employees, must be brought exclusively in the state or federal court of general jurisdiction closest to where our principal business address then is located. You (and each Owner) irrevocably submit to the jurisdiction of such court and waive any objection you, he, or she may have to either jurisdiction or venue.

This forum selection clause probably meant to allow judicial actions to be brought in either the federal or state court for the district in which the franchisor is located. But, read literally, whichever courthouse is actually closest to the franchisor’s principal place of business is the court where the action must be filed. The following forum selection clauses achieve the intended result of allowing an action to be brought in federal or state court without ambiguity:

**Forum Selection Clause – Example 7**

“Except as otherwise expressly provided by applicable state law or regulation, the parties agree that the exclusive venue and jurisdiction of any suit arising hereunder shall lie within the courts of the State of Texas located in [___________], Texas, or within the courts of the United States of America located within the [___________] District of Texas.

**Forum Selection Clause – Example 8**

“. . . shall be resolved by a legal proceeding in a court in the judicial district in which Franchisor has, at the time of the commencement of such legal proceeding, its principal place of business, and Franchisee irrevocably accepts the venue and jurisdiction of the courts of the state, and federal courts located in the judicial districts, in which Franchisor has, at the time of the commencement of such legal proceeding, its principal place of business for such claims . . . .”

**B. State Anti-Waiver Statutes**

At least 15 states, California, Connecticut, Illinois, Indiana, Iowa, Louisiana, Maryland, Michigan, Minnesota, New Jersey, North Carolina, North Dakota, Rhode Island, South Carolina and Wisconsin, have statutes, regulations and/or judicial decisions which prohibit enforcement of a forum selection clause in franchise agreements which would require a franchisee located in
the state to bring a lawsuit against the franchisor in a forum outside of the state. In those states, courts have refused to enforce forum selection clauses in situations where the franchisee doing business in the state brings an action against the franchisor in the state rather than in the designated forum. In *Jones v. GNC Franchising, Inc.*, 211 F.3d 495 (9th Cir. 2000), the franchisee sued the franchisor in California although the contractual forum selection clause required all actions to be brought in a Pennsylvania court. The trial court refused to enforce the forum selection clause because California’s anti-waiver statute “establishes a strong public policy against enforcing such clauses in franchise agreements . . . .”

Even if a franchisor cannot enforce a forum selection clause to bar a franchisee from suing the franchisor outside of the designated forum, will the franchisor be precluded from suing the franchisee in the designated forum? The answer could be yes, depending upon the conflicts law of the designated forum.

In a recent unpublished opinion, a federal district court which was designated in a forum in a forum selection clause, dismissed the franchisor’s action against a California franchisee because of California’s strong public policy against forum selection clauses. The court concluded that the forum state’s conflict of law rules would, under principles of “fundamental fairness,” honor a sister state’s statutes invalidating contractual provisions involving a member of a protected class of citizens. This application of the forum state’s conflicts of law rules might have been avoided if the forum selection clause had excluded application of the conflicts of law rules of the designated forum.

Adding language to a forum selection clause barring a franchisee from contesting venue of an action brought by the franchisor and barring application of the forum’s conflict of laws rules, may avoid the concern that a court would dismiss a franchisor’s action in the designated forum in favor of the forum where the franchisee is located. Consider the following modification of forum selection clause Example 1:

> “Any and all disputes between Franchisor and Franchisee shall be brought only in a court of competent jurisdiction located in the County of Los Angeles, California. Franchisee irrevocably submits to the jurisdiction of such courts without recourse to California conflicts of law rules and further waives and agrees not to assert, move or otherwise claim that this venue is for any reason improper, inconvenient,

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21 *Id.* at 497. In *E & J Gallo Winery v. Morand Bros. Beverage Co.*, 247 F. Supp. 2d 979, 987 (N.D. Ill. 2003), an alcoholic beverage manufacturer brought suit against its Illinois distributor in Illinois, as required by Illinois law, and then sought to transfer the case to California pursuant to a forum selection clause in the distributorship agreement. The court invalidated the forum selection clause as against public policy because Illinois law required lawsuits relating to Illinois malt beverage agreements be brought in Illinois.
prejudicial or otherwise inappropriate (including any claim under the judicial doctrine of forum non conveniens).”

VI. CHOICE OF LAW CLAUSES

A. General Enforceability

Most states follow the Restatement (Second) of Conflicts § 187 which provides that courts should apply the state law chosen by the parties to govern their contractual rights and duties unless (1) the chosen state has no substantial relationship to the parties or to the transaction and there is no other reasonable basis for the parties’ choice; or (2) application of the law of the law of the chosen state would be contrary to a fundamental policy of a state that has a materially greater interest than the chosen state in the determination of the dispute or whose law would apply absent the choice of law provision. Assuming the choice of law provision is otherwise valid, the drafter should carefully consider the scope of the designated law. Will the chosen law apply to franchise law claims only or all disputes between the parties? Will federal law apply to trademark claims? Will the chosen law be given extraterritorial effect?

If the choice of law is from a state without any franchise laws, the choice of law provision can be relatively simply, such as the following:

**Choice of Law - Example 1**

“This Agreement shall be interpreted and construed under the laws of the State of Texas except to the extent governed by the United States Trademark Act of 1946 (Lanham Act, 15 U.S.C. Section 1051 et seq.)

The foregoing choice of law provision narrowly applies Texas law only to issues related to the interpretation and construction of the franchise agreement. The following are two examples of broadly applicable choice of law provisions:

**Choice of Law - Example 2**

“Franchisee acknowledges that Franchisor may grant numerous franchises throughout the United States on terms and conditions similar in certain material respects to those set forth in this Agreement, and that it is of mutual benefit to Franchisee and to Franchisor that these terms and conditions be uniformly interpreted. Therefore, the parties agree that Texas law (except for Texas choice of law rules) shall apply to all matters arising under or relating to this Agreement, including the interpretation and construction of this Agreement and shall govern all questions which arise with reference to this Agreement or the relationship of Franchisor to Franchisee.

**Choice of Law - Example 3**

“We each agree that the State of New York has a deep and well developed history of business decisional law. For
this reason, we each agree that except to the extent governed by the United States Trademark Law of 1946 (Lanham Act, 15 U.S.C. § 1050 et seq.), as amended, this Agreement, all relations between us, and any and all disputes between us, whether sounding in contract, tort, or otherwise, are to be exclusively construed in accordance with and/or governed by (as applicable) the laws of the State of New York without recourse to New York (or any other) choice of law or conflicts of law principles.”

Both Example 2 and Example 3 recite the basic reasons why the parties considered it important to choose the particular state law which will be applied. But Example 3 makes it clearer than Example 2 that the chosen law applies to any and all disputes which might arise between the franchisor and the franchisee.

Example 3 also accounts for the possibility that a provision in the agreement would not be enforced under New York law, in which case the law of the state where the franchisee is located, is applied and excludes extension of New York franchise laws that would not otherwise apply22:

“If, however, any provision of this Agreement would not be enforceable under the laws of New York, and if the Facility is located outside of New York and the provision would be enforceable under the laws of the state in which the facility is located, then the provision in question (and only that provision) will be interpreted and construed under the laws of that state. Nothing in this section is intended to invoke the application of any franchise, business opportunity, antitrust, ‘implied covenant,’ unfair competition, fiduciary or any other doctrine of law of the State of New York or any other state which would not otherwise apply absent this paragraph.”

B. State Anti-Waiver Laws

Several states with franchise disclosure and franchise relationship laws have anti-waiver provisions to insure franchisees residing or operating in the state have the protection afforded by state law. But those laws do not necessarily void a choice of law provision.23

22 In Cromeens, Holloman, Sibert, Inc. v. AB Volvo, 349 F.3d 376, 385 (7th Cir. 2003), the court concluded that the contractual choice of law provision which designated Illinois law included the territorial limitations of the law: “A number of courts have held that a state’s territorial limitations apply even when that state’s law is selected for application by a choice-of-law provision.”

VII. INTEGRATION CLAUSES AND DISCLAIMERS

A. Additional Terms Cannot Be Added To An Integrated Contract

The parol evidence rule provides that when a document is fully integrated, no additional terms may be added, whether consistent or inconsistent, through parol evidence.24 An “integration clause” is a “contractual provision stating that the contract represents the parties’ complete and final agreement and supersedes all informal understandings and oral agreements relating to the subject matter of the contract.”25 Although not dispositive, an integration clause creates a strong presumption that the document is fully integrated.26

B. Fraudulent Inducement May Be Shown By Extrinsic Evidence

An exception to the parol evidence rule allows extrinsic evidence to establish fraud provided the evidence does not contradict the express terms of an integrated agreement. “[I]t must tend to establish some independent fact or representation, some fraud in the procurement of the instrument or some breach of confidence concerning its use, and not a promise directly at variance with the promise of the writing.”27 Evidence of fraud which is not contrary to the terms of an agreement is not barred by the parol evidence rule.

The parol evidence rule rests on the assumption that a valid agreement exists. Thus, “it does not exclude evidence to show that there was no agreement or that the agreement was invalid.”28 Evidence of fraud which is contrary to the terms of the agreement may be admitted to show the agreement is void and unenforceable.29 A plaintiff fraudulently induced to enter into a contract can either affirm the contract and sue for damages, in which case the integration clause applies, or rescind the contract and sue for restitution, in which case the integration clause does not apply.30

26 Specht v. Netscape Comm. Corp., 306 F.3d 17, 36-37 (2d Cir. 2002)(applying California law); Telecom Int’l America, Ltd. v. AT&T Corp., 280 F.3d 175, 191 (2d Cir. 2001); Rosenblum v. Travelbyus.com Ltd., 299 F.3d 657, 665 (7th Cir. 2002)(“A merger clause, in effect, assures the parties that their entire agreement is memorialized in the written contract, and permits either party to invoke the parol evidence rule to exclude evidence of additional contractual terms not included in the written agreement.”).
27 Id. at 281, quoting, Bank of America Nat’ Trust & Sav. Ass’n v. Pendergrass, 4 Cal. 2d 258, 48 P.2d 659, 661 (1935).
29 See Restatement Second) Contracts § 214 (1981); Manufacturers Hanover Trust co. v. Yanakas, 7 F.3d 310, 315 (2d Cir. 1993).
C. Specific Disclaimer May Preclude Fraudulent Inducement Claims

However, by making specific disclaimers of possible misrepresentations in the agreement, a party may preclude a subsequent fraudulent inducement claim. In Consolidated Edison, Inc. v. Northeast Utilities, 249 F Supp. 2d 387, 401 (S.D.N.Y 2003), the court explained that “where a party specifically disclaims reliance upon a particular representation in a contract, that party cannot, in a subsequent action for common law fraud, claim it was fraudulently induced to enter into the contract by the very representation it has disclaimed reliance upon.”

D. Examples Of Integration And Disclaimer Clauses

The following is a simple form of integration clause which may not effectively bar claims of misrepresentation which are not specifically disclaimed in the franchise agreement:

Integration Clause – Example 1

“This Agreement . . . constitutes the entire agreement of the parties and supersedes all prior negotiations, commitments, representations and undertakings of the parties with respect to the subject matter of this Agreement.”

This form of integration clause should be sufficient to bar any claim that the franchisor made an agreement to take any action which is not expressly provided for in the franchise agreement. But it may not preclude extrinsic evidence of representations not specifically disclaimed. For example, suppose the franchisee alleges the franchisor told him that his store would have gross sales of $100,000 per month after the second month. Such a representation does not actually contradict a representation in the integration clause and there is no specific disclaimer else where in the document which it does contradict.

An example of an integration clause which more clearly disclaims making any representation, rather than merely stating that prior representations are superseded would be the following:

Integration Clause – Example 2

“This Agreement together with the documents referred to herein and the Attachments hereto, if any, constitute the entire, full and complete agreement between the parties hereto concerning the subject matter hereof, and supersede all prior agreements with no other representations having induced Franchisee to execute this Agreement.”

The advantage of this integration/disclaimer clause is that it clearly states that there were no representations which may have induced the franchisee to enter into the franchise agreement. Thus, if the franchisee seeks to rescind the franchise agreement based upon fraudulent inducement, the franchisor will be able to assert that the franchisee could not have relied upon the fraud because the disclaimer is an admission that no reliance occurred.

A general integration and disclaimer clause with specific disclaimers of various possible claims would be even more effective. If the franchisee was fraudulently induced to enter into the franchise agreement and moved to rescind the agreement, the claim set forth in Example 2 would not be applied. It does not expressly disclaim any particular misrepresentation and so provides little benefit in a rescission action. The following would be more effective:

**Integration Clause – Example 3**

(a) This agreement constitutes the entire agreement between the Franchisor and the Franchisee concerning the subject matter hereof. All prior agreements, discussions, representations, warranties and covenants are merged herein.

(b) There are no warranties, representations, covenants or agreements, express or implied, between the parties concerning the subject matter hereof, including, without limitation, any implied covenant of good faith and fair dealing, except those expressly set forth in this agreement.

(c) Franchisee represents and warrants that Franchisee has placed no reliance on any oral or written statements, whether referred to as representations, warranties, inducements or otherwise, which are not contained in this Agreement.

(d) Franchisee represents and warrants that no claims, representations or warranties regarding the earnings, sales, profits, success or failure of the franchised business have been made to Franchisee and no such claims, representations or warranties have induced Franchisee to enter into this Agreement. Franchisor disclaims making any claims, representations, or warranties to Franchisee or his agents regarding the earnings, sales, profits, success or failure of the franchised business.

(e) Franchisee represents and warrants that Franchisee has entered into this Agreement after making an independent investigation of Franchisor's operations and the Franchise System.

(f) Franchisee acknowledges that Franchisor’s approval of the franchise location does not constitute any assurance by Franchisor that the business location will be successful or profitable.

(g) Franchisee represents and warrants that Franchisee has read this Agreement in its entirety and understands its contents; has been given the opportunity to clarify with Franchisor any provisions hereof that Franchisee did not understand; and has had the opportunity to consult with an
attorney, an accountant and/or other professional advisor regarding the operation and effect of the Agreement and the operation of the Franchise System.

(h) Franchisee represents and warrants that Franchisee, together with Franchisee’s advisors, has sufficient knowledge and experience in financial and business matters to make an informed investment decision with respect to the Franchise.

(i) Franchisee represents and warrants that it received a copy of the Franchise Offering Circular not later than the earlier of the first personal meeting held to discuss the sale of a license, ten (10) business days before the execution of this Agreement or ten (10) business days before any payment of any consideration.

VIII. TERRITORIAL EXCLUSIVITY OR LACK THEREOF

A. Franchise Agreements Should Specify Both The Territorial Rights Granted To The Franchisees And Retained By The Franchisors

Certainly as much and possibly more than any other area of dispute between franchisors and franchisees, issues of territorial exclusivity and franchisor encroachment have focused on the precise language of territorial provisions. Before Scheck v. Burger King Corp., 756 F. Supp. 543 (S.D. Fla. 1991), it was generally assumed that the franchisor retained any and all rights to operate and franchise others to operate the franchised business or any other business except to the extent expressly granted to the franchisee. But from cases such as Scheck, Camp Creek Hospitality Inns, Inc. v. Sheraton Franchise Corp., 139 F. 3d 1396 (11th Cir. 1998), and others, it has become clear that the limitations inherent in the grant of a franchisee’s territorial rights do not necessarily define the franchisor’s rights. Franchise agreements should define the extent of both the franchisee’s territorial rights and the franchisor’s reservation of territorial rights.

The following two examples from current franchise agreements illustrate the basic grant of franchise with and without territorial rights:

no territorial protection:

Franchisee acknowledges and agrees that this franchise relates solely to the Approved Location and this Agreement does not entitle Franchisee to any protected territory, territorial rights or exclusivity.

with territorial protections:

Franchisor grants Franchisee a franchise to own and operate an XYZ store at, and only at, the premises and a protected area (“Protected Area”) surrounding the location of the XYZ store as set forth in Exhibit A.
Both of these grants would need to be coupled with express reservations of rights to insure that the franchisor can

(1) operate, directly or through others, an XYZ store anywhere outside of the defined territory;

(2) operate, directly or through others, a competing business with different marks anywhere inside or outside of the protected territory;

(3) operate, directly or through others, a non-competing business with the XYZ store marks anywhere inside or outside of the protected territory;

(4) operate, directly or through others, a version of the XYZ store in limited access or non-traditional venues such as malls, mail order, world wide web, grocery stores, highway rest stops, stadiums, and airports;

(5) sell the products supplied to the XYZ store or other products using the XYZ marks, through limited access or non-traditional venues.

The basic grant of franchise may be further restricted by the franchisor’s reservation of rights:

**Franchisee acknowledges and agrees that Franchisor, its subsidiaries, affiliates and partners have and retain the right to develop, acquire, and operate and license others to develop, acquire and operate any business of any type whatsoever, whether under the Marks or as a competitive brand or otherwise, at any location (except the Approved Location) including locations adjacent, adjoining or proximate to the Approved Location, and that such business operations may compete directly with and adversely affect the operations of the Franchised Business.**

**Franchisor reserves the right to engage in any other businesses, even if those business compete with Franchisee’s franchised business, whether Franchisor starts those businesses, or purchases, merges with, acquires, is acquired by, or affiliates with, such businesses.**

**Franchisee agrees that Franchisor may exercise such rights from time to time without notice to Franchisee, and Franchisee covenants that it shall not take any action, including any cause of action in a court of law or equity, which may interfere with the exercise of such right by Franchisor.**

**Franchisor retains the right, in its sole discretion and without granting any rights to Franchisee, to sell the products and services authorized for the XYZ store under other trademarks, service marks and commercial symbols through**
similar or dissimilar channels of distribution and pursuant to conditions Franchisor deems appropriate.

Many franchise agreements initially provide that the franchisee has no protected territory and then provides that the franchisor will not operate within a protected territory provide the franchisee is in compliance with the terms of the franchise agreement. The following are typical provisions:

Provided Franchisor is in compliance with all terms and conditions of this Agreement and all other agreements between Franchisor and Franchisee, Franchisor agrees that during the Term it will not own, operate or manage another XYZ store nor grant to another person the right to own, operate or manage an XYZ store at a location within the Protected Area.

During the Term and for so long as no Event of Default has occurred and is continuing and no event has occurred which, with the giving of notice or lapse of time, or both, would constitute an Event of Default, Franchisor will not develop, or operate, nor authorize any other person to develop or operate, a XYZ store within the Protected Territory.

Both of these provisions create an ambiguity with respect to the limitation which exists if the franchisee was in default, but cured the default at any time. Suppose the XYZ store franchisee was in default of the franchise agreement, the franchisor gave notice of the default and the franchisee cured the default. During the period of default, the franchisee is not in compliance with the franchise agreement and the franchisor would have the right to open and operate its own XYZ store. If the franchisor did so and then the default was cured, could the franchisor continue to operate the new store? The answer would appear to be no. The provision clearly states that while the franchisee is in compliance, the franchisor shall not own or operate an XYZ store. It does not provide that all such stores granted during the window of opportunity can continue to operate.

The second example states that the franchisor can develop and operate an XYZ store so long as the Event of Default has occurred and is continuing. If the Event of Default is cured, it is not continuing and the right to operate, which is a continuing event, is lost.

The following is suggested as a possible solution to the ambiguity:

During the Term, Franchisor will not develop or operate and will not authorize any other person to develop or operate an XYZ store within the Protected Territory; provided that if there is an Event of Default or an event has occurred which, with the giving of notice or lapse of time, or both, would constitute an Event of Default, Franchisor is authorized, without notice to Franchisee, to develop and operate or to grant to any other person the right to develop and operate, an XYZ store within the in the Protected Area which authorization shall not be affected by Franchisee’s subsequent cure of the Event of
Default or of the event which, with notice or the passage of time would have resulted in an Event of Default.

IX. TRANSFER AND RELOCATION PROVISIONS

A. Relocation Of Franchise Location

Most franchise agreements are site specific in that the agreement grants the franchisee the right to operate the franchised business at a specific approved location. The following provisions are typical of many retail franchises:

Franchisor hereby grants Franchisee the right to operate the Franchised Business only at the specific location which will be selected by the Franchisee . . . . Franchisee is granted the rights described herein only for the approved site.

and

Franchisor grants Franchisee a license to use the System solely in the Territory at the site mutually agreed upon . . . .

Surprisingly, not all franchise agreements set forth the terms and conditions for relocation of the franchised business. The failure to address this issue could force the franchisor to allow relocation in circumstances it would not otherwise be willing to accept.

It is now reasonably well established that the covenant of good faith and fair dealing will not be used to defeat express contract provisions. But when there is no contract language permitting the franchisor to withhold consent for relocation or to withhold consent absent specific conditions, the court may imply an obligation to consent to relocation.

The following example of relocation provisions should be considered for inclusion in the franchise agreement:

Example 1: No relocation without consent in the franchisor’s sole discretion.

Franchisee shall not relocate the Franchised Business at any time for any reason without the prior written consent of the Franchisor which consent may be withheld for any reason in the sole and absolute discretion of the Franchisor.

Example 2: Consent to relocation will not be unreasonably withheld.

Franchisee shall not relocate the Franchised Business at any time for any reason except within the Territory and then only with the prior written consent of the Franchisor which consent shall not be unreasonably withheld.
Example 3: Relocation on stated conditions.

Franchisee shall not relocate the Franchised Business at any time for any reason except that Franchisee may relocate the Franchised Business to a new location within the Territory upon the following conditions and no others:

1. Franchisee shall not be in default of any provision of this Agreement or lease of the former location.

2. Franchisee shall deliver to Franchisor a current financial statement, including a profit and loss statement for the Franchised Business during the last twelve (12) months of operation at the former location, and a copy of the lease for the new location.

3. The new location shall be located, constructed and equipped in accordance with the Franchisor’s then-current site selection standards, design standards and other applicable specifications for a new Franchised Business.

4. Franchisor consents in writing to the new location which consent shall not be unreasonably withheld.

5. Franchisee is current on all of Franchisee’s financial obligations to Franchisor and its affiliates.

6. Franchisee gives Franchisor written notice of the proposed relocation ____ days before the relocation date.

7. The Franchised Business opens for business in the new location within ____ days after the old location is closed.

8. Franchisee shall enter into an agreement terminating this Agreement and shall execute Franchisor’s then-current form of Franchise Agreement except that the term of the new Franchise Agreement shall expire on the same date as this Agreement and there shall be no requirement for a new initial franchise fee.

9. Franchisee shall pay Franchisor’s reasonable costs in approving the new location.

Less onerous relocation conditions could be considered in the following example:

Example 4: Consent to relocation with conditions.

Franchisee shall not relocate the Franchised Business at any time for any reason except that if (i) Franchisee loses the right to occupy the Premises during the term of this agreement or any renewal hereof, other than as a result of
default by the Franchisee or (ii) Franchisor and franchisee agree there is a change in the character of the location of the Store sufficiently detrimental to its business potential to warrant its relocation, then Franchisee may apply for relocation of the Store. Franchisor shall grant Franchisee’s application to relocate the Store subject to the following conditions:

1. The new location shall comply with Franchisor’s then current site location criteria.

2. The Franchisee shall pay Franchisor a relocation fee in the amount of $________ for services Franchisor will render in connection with the relocation of the Store.

3. Notify Franchisor at least ___ days in advance of the proposed last day of business at the current location and reopen the Store within _____ days at the new location.

4. Be in compliance with the terms of this Franchisee Agreement and any related or successor agreements.

B. Transfer Of Ownership

1. **Transfer Of Franchise Agreement By Franchisor**

   It would appear, after reviewing scores of franchise agreements, that all agreements have a provision which allows the franchisor to transfer and assign the franchise agreement. The following is a typical example of such a provision:

   Franchisor shall have the right to transfer or assign this Agreement or any of Franchisor’s rights or obligations hereunder to any person or legal entity.

   But surprisingly, not a single franchise agreement contains a provision releasing the franchisor from its obligations to the franchisee after assignment of the franchise agreement.

   It is well established contract law that assignment of a person’s rights and obligations under a contract does not release the assignor of continuing liability if the assignee fails to perform the assignor’s obligations.32 “Courts generally enforce contract clauses which

   32 Boswell v. Lyon, 401 N.E.2d 735, 744 (Ind. App. 1980)(Under Indiana law, an assignor remains liable on the contract after the assignment as a surety.)
continue to hold assignors liable on a contract even after a valid assignment. Absent a novation, an assignor’s liability on a contract cannot be assigned.

In order to effect a novation of a franchisor’s liability under the franchise agreement if the agreement is assigned to a new franchisor, the following provision should be considered:

Franchisor shall have the right to assign this Agreement or any of Franchisor’s rights or obligations hereunder to any person or legal entity. Upon consummation of any such assignment, Franchisee shall release and hold harmless Franchisor from any and all future liability under any of the terms, covenants and conditions, express or implied, contained in this Agreement which shall have been assigned, and Franchisee agrees to look solely to the assignee for performance of Franchisor’s obligations hereunder which shall have been assigned.

2. **Transfer By Franchisee**

Although an absolute prohibition against transferring the franchise generally will be enforced, nearly all franchise agreements grant the franchisee at least a qualified right to transfer the franchise. The reasons for granting the franchisee a right to transfer the franchise should be obvious. Most franchisees are not likely to invest their time, effort and money in a franchised business which has no exit strategy to allow the franchisee to withdraw the value which has been invested and accumulated. The franchisor can also realize several benefits from granting transfer rights: financial account can be brought current; the franchise unit can be up-dated to the then-current standards; an existing unit can be re-invigorated; the new franchisee can be trained according to the franchisor’s then-current standards; the franchisor may have an opportunity to acquire the franchised unit as a company owned unit.

Whatever reasons the franchisor deems important for allowing the franchisee to transfer a franchised business will dictate how the franchise agreement is drafted. However, there are at least six issues which should be considered and addressed:

a. **No Transfer Without Franchisor Approval**

The franchise agreement should recite that the rights granted in the agreement are personal to the franchisee and cannot be transferred without the franchisor’s prior written consent. The following example [Batteries Plus]


34 Kirst v. Silna, 103 Cal. App. 3d 759, 764 (1980). “The assignment of a lease by the lessee does not discharge him from the duty to pay the agreed rent. [Citation.] This is true even though the lessor assents to the assignment, unless it is agreed that the lessee shall be discharged and the assignee substituted as sole obligor.” Corbin on Contracts § 866 at n.31

35 Any applicable state law should be examined. For example, in Hawaii it is unlawful for a franchisor to refuse to permit the transfer of the franchise except for good cause. Haw. Rev. Stat. § 482E-(6)(I).
FRANCHISEE MAY NOT TRANSFER THE AGREEMENT WITHOUT THE APPROVAL OF THE FRANCHISOR

Franchisee understands and acknowledges that the rights and duties created by this Agreement are personal to Franchisee (or, in the case of a legal entity Franchisee, its owners) and that Franchisor has granted the Franchise in reliance upon Franchisee’s individual or collective character, skill, aptitude, attitude, business ability and financial capacity. Accordingly, except as provided with respect to a transfer to a corporation, Franchisee shall not, voluntarily or involuntarily, directly or indirectly, by operation or law or otherwise, sell, assign, transfer, convey, subdivide, sub-franchise, give away, pledge, mortgage or otherwise encumber (collectively referred to as a “Transfer”) all or any interest in (1) the Franchise, (2) this Agreement, (3) the Franchised Business, (4) the Premises or (5) Franchisee’s ownership, if the Franchisee is a legal entity without Franchisor’s prior written consent. Any such purported Transfer, including any Transfer by a trustee in bankruptcy, without Franchisor’s prior written consent shall be null and void; shall constitute a breach of this Agreement; and shall not convey any rights to or interest in the Franchise, this Agreement or the Franchised Business.

b. Conditions For Approval Of Transfer

A franchisor may have any number of conditions for granting approval of the transfer depending upon specific concerns of the franchisor. The following conditions would be typical:

CONDITIONS FOR APPROVAL OF TRANSFER

If Franchisee is in full compliance with this Agreement, Franchisor shall not unreasonably withhold its approval of an assignment or transfer of the Franchise, the Franchised Business, this Agreement or the Leases provided the proposed assignee is of good moral character, has sufficient business experience, aptitude and financial resources to own and operate the Franchise Business, meets the Franchisor’s then-applicable standards for franchisees, and provided further that Franchisor may require that any one or more of the following conditions have been met before or concurrently with the effective date of the assignment:

1. all of Franchisee’s obligations have been assumed by the proposed assignee;

2. the proposed assignee agrees to complete the training program required for new franchisees;
3. if required, the lessor of the premises has approved the assignment;

4. the franchisee or proposed assignee pay Franchisor’s standard franchise fee;

5. the Franchisee signs a release in the form and substance satisfactory to franchisor;

6. Franchisor shall have approved the material terms of the proposed assignment; and

7. the proposed assignee signs the then current franchisee agreement.

c. Transfer Upon Death Or Disability

Most franchisors allow the heirs or estate of a deceased franchisee or owner of the franchisee to succeed to the decedent’s interest in order to sell the franchise. In California, the surviving spouse, heir or estate of a deceased franchisee or majority owner of the franchisee is allowed to participate in the operation of the franchise for a reasonable time after the death of the franchisee or majority owner. During that time, the spouse, heir or estate must either satisfy the requirements to become the franchisee or sell the franchise to a person who does satisfy those requirements.\(^{36}\)

If the deceased or disabled franchisee or owner of the franchisee was the manager or principal operator of the franchised business, then the franchise agreement should require the estate to appoint a competent manager immediately.

The following provision is an example of how a franchisor can provide for a transfer upon death or disability:

**TRANSFER UPON DEATH OR DISABILITY**

1. If the Franchisee or the principal owner of the Franchisee was the manager of the Franchised Business, then upon the death or permanent disability of the Franchisee or the principal owner of the Franchisee, the executor or personal representative of the Franchisee or principal owner of the Franchisee shall, within 30 days after the death or disability, appoint a qualified manager to operate the Franchised Business. The manager must satisfactorily complete Franchisor’s training program within a reasonable time which shall not exceed 30 days after the manager's

appointment. Failure to appoint a qualified manager as herein provided shall constitute a breach of the Agreement.

2. Permanent disability shall mean any physical, emotional or mental injury, illness or incapacity which would prevent a person from performing the obligations set forth in this Agreement for at least ninety (90) days from the date of the determination of disability. Permanent disability shall be determined by a licensed practicing physician, selected by Franchisor, upon examination of the person. If the person refuses to submit to an examination, then such person shall be automatically deemed permanently disable as of the date of such refusal or purposes of this section.

3. Upon the death or permanent disability of the Franchisee or the principal owner of the Franchisee, the executor or personal representative of such person shall, within ___ months after the death or disability, transfer Franchisee’s interest in the Franchise, the Franchised Business, and this Agreement or the principal owner’s interest in the Franchisee to the surviving spouse, heirs or estate of such person or to another party provided such transferee meets the Franchisor's then current standard for becoming a franchisee and is approved by the Franchisor.

d. Transfer To A Corporation Or Limited Liability Company

For financial and liability concerns, an individual franchisee may want to operate in a corporate form. If so, the following provision would be appropriate:

ASSIGNMENT TO CORPORATION OR LIMITED LIABILITY COMPANY

If Franchisee is an individual, then Franchisee may, upon notice given to the Franchisor, assign this Agreement and the assets and liabilities of the Franchised Business to a corporation or limited liability company (“LLC”) provided (1) the corporation or LLC conducts no business other than operation of the Franchised Business, (2) the corporation or LLC will be actively managed by the Franchisee, and (3) the Franchisee will, at all times during the term hereof, own and control all of the shares and voting power of the corporation or LLC. An assignment hereunder shall not relieve Franchisee of his obligations and the Franchisee and the corporation or LLC shall be and remain jointly and severally liable for all obligations under this Agreement and any other agreement between
e. Franchisor’s Right Of First Refusal

The following is an example of a right of first refusal.

FRANCHISOR’S RIGHT OF FIRST REFUSAL

If the franchisee determines to sell or to transfer for consideration the Franchise, the Franchised Business, the Agreement, the Premises or an interest in Franchisee, Franchisees or its owners must obtain a bona fide, executed written offer from a responsible and fully disclosed purchaser and must submit an exact copy of the offer to Franchisor. Franchisor has the right, exercisable by written notice delivered to Franchisee or its owners within 30 days from the date of delivery of an exact copy of the offer to Franchisor to purchase the interest being offered for the price and on the terms contained in the offer, provided that Franchisor may substitute cash for any form of payment proposed in the offer and has a minimum of 60 days to prepare for closing. If Franchisor does not exercise its right of first refusal, Franchisee or its owners may complete the sale to the purchaser pursuant to and on the terms offered in accordance with the terms and conditions of this Agreement, provided that if the sale to purchaser is not completed within one hundred twenty (120) days after delivery of the offer to the Franchisor or if there is a material change in the terms of the sale, Franchisor again has the right of first refusal.

f. Approval Of Transfer Does Not Waive Claims

Consent to a transfer of the Franchisee’s rights and obligations under the franchise agreement is not automatically a relinquishment of the franchisee’s obligations to the franchisor. However, to be certain no implied relinquishment results from an approved transfer and to put the franchisee on notice that he or she remains liable, it is a good practice to specifically provide that waiver of claims does not result from approval of a transfer.

NON-WAIVER OF CLAIMS

Franchisor’s consent to a transfer of any interest in the Franchise, the Franchised Business or this Agreement shall not constitute a waiver or release of the transferring party’s obligations under this Agreement or any other agreement it entered into with the Franchisor or of any claims Franchisor may then have against the transferring party.

X. PRIVACY ISSUES

Compliance with privacy laws became a concern franchise counsel could not ignore with the enactment of the Children’s Online Privacy Protection Act (COPPA), 15 USC §§ 6501-6505, in 1998, the establishment of Do Not Call regulations by the Federal Trade Commission and the Federal Communications Commission in 2003, and the enactment of the Controlling the Assault
of Non-Solicited Pornography and Marketing Act of 2003 (CAN-SPAM Act), 15 USC §§ 7702-7713. Other ABA presentations have discussed the new laws and regulations which franchisors need to be aware of and this paper is not intended to address all of those laws. Doing so is well beyond the scope of this paper. However, there is an area of state privacy laws which has not been adequately addressed.

Currently, there is no federal law or regulation of general application that prohibits the use, disclosure or destruction of non-public personal information. There are important exceptions which regulate the collection and disclosure of personal information in different commercial settings which may apply to some franchisors. The Gramm-Leach-Bliley Act, 15 U.S.C. §§ 6801-6809, restricts the ability of “financial institutions” to disclose non-public personal information about consumers to non-affiliated third parties. The Health Insurance Portability and Accountability Act, 42 U.S.C. § 1306, restricts the ability of health care providers and certain others from disclosing personal health information. The Children’s Online Privacy Protection Act, 15 U.S.C. §§ 6501-6505, applies to the collection of personal information from children under the age of 13. But those laws have little impact on most franchise relationships.

A. California Information Practices Act Of 1977

Although generally applicable federal privacy laws and regulations are lacking, states have moved to fill the void. California was the first to act when it amended the Information Practices Act of 1977 between 2000 and 2003, to provide security for personal information collected from California residents by a business. California’s privacy protection laws cannot be waived. A customer injured by a violation of the law can recover damages and a business that violates the law can be enjoined. Many other states have followed California’s lead in protecting personal information being shared with a non-affiliated business and mandating notice if there is a security breach. These laws have important applications where the franchisee collects and maintains personal information, but that information is owned or controlled by the franchisor.

1. Destruction of Records Containing Personal Information

Effective January 1, 2001, a business which has custody or control of customer records which contain personal information must take reasonable steps to destroy those records when they are no longer retained. For purposes of this provision, “personal information” means “any information that identifies, relates to, describes, or is capable of being associated with, a particular individual, including, but not limited to, his or her name, signature, social security number, physical characteristics, or description, address, telephone number, passport number, driver’s license or state identification card number, insurance policy number, education,
employment, employment history, bank account number, credit card number, debit card number, or any other financial information."  

A "business" is any sole proprietorship, partnership, corporation, association or other group. "Records" means any material on which information is recorded or preserved by any means regardless of the physical form, but does not include publicly available directories containing information voluntarily disclosed for public dissemination. A "customer" means an individual who provides personal information to a business for the purpose of purchasing or leasing a product or obtaining a service from the business. 

Suppose a franchisee collects personal information from customers who reside in California. Clearly the franchisee has an obligation under California law, whether or not the franchisee conducts business in California, to insure the personal information is disposed of in accordance with California law. But what about the franchisor, does it has a similar obligation? Although most franchise agreement do not expressly provide who owns customer information, a good argument could be made in most cases that the franchisor has an implied ownership or control over customer information. Thus, a franchisor could be deemed to be a business with control, if not custody, of customer records containing personal information, and has an obligation to take reasonable steps to destroy such information when it is disposed of. 

To insure franchisee compliance with California law, a franchisor should consider adding the following provision to the franchise agreement:

"Customer Information” shall mean any and all information that Franchisee obtains, directly or indirectly, regarding customers of the Franchise Business that identifies, describes or is associated with a particular individual, including but not limited to, the customer's name, signature, address, telephone number, e-mail address, passport number, driver's license number, social security number, state identification number, bank account number, credit card number, debit card number, or any other financial information.

Franchisee shall not dispose of any Customer Information, regardless of the physical form in which such information is maintained, in the possession, custody or control of Franchisee except in conformity with the procedures set forth in the Operations Manual.

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41 Id. at § 1798.80(e).
42 Id. at § 1798.80(a).
43 Id. at § 1798.80(b).
44 Id. at § 1798.80(c).
2. Security Measures Required To Protect Personal Information

Effective as of January 1, 2005, California law provides that “[a] business which owns or leases personal information about a California resident shall implement and maintain reasonable security procedures and practices appropriate to the nature of the information, to protect the personal information from unauthorized access, destruction, use, modification or disclosure.” California also provides that “[a] business that discloses personal information about a California resident pursuant to a contract with a nonaffiliated third party shall require by contract that the third party implement and maintain reasonable security procedures and practices appropriate to the nature of the information, to protect the personal information from unauthorized access, destruction, use, modification, or disclosure.” This provision of the Investment Practices Act of 1977 has the potential for causing serious concern to franchisors in their relation with franchisees.

Suppose, for example, that a hotel located in Nevada collects personal information regarding California residents and that the franchise agreement provides that all personal customer information collected by the franchisee is the property of the franchisor. In that case, the franchisor may be required to implement and maintain reasonable security procedures and practices and to have a contract with the franchisee to require the franchisee to implement and maintain reasonable security procedures and practices. The franchisee, having collected and disclosed the customer information to the franchisor pursuant to the requirements of the franchise agreement, may also have a direct obligation to implement and maintain a reasonable policy. Whether the franchisor or franchisee has any such obligation will depend upon whether there is “personal information” being collected and retained.

For purposes of requiring a business to implement and maintain a reasonable security policy, “personal information” is more narrowly defined to mean “an individual’s first name or first initial and his or her last name in combination with any one or more of the following data elements, when either the name or data elements are not encrypted or redacted:” (1) social security number, (2) driver’s license number, or (3) account number, credit card or debit card number in combination with a security code that would allow access of the card information, or (4) medical information when either the name or the data element is not encrypted. Thus, if the franchisee does not collect any of the data elements, there is no obligation to implement and maintain a security policy. Although having such a policy may be important to the franchisor, having a legal obligation to implement and maintain such a policy may be better avoided.

Consider the following provision in the franchise agreement to insure the franchisee does not collect or maintain “personal information” which would implicate the provision that requires a security policy:

45 Id. at § 1798.81.5(b).
46 Id. at § 1798.81.5(c).
47 Id. at § 1798.81.5(d).
Franchisee shall not, directly or indirectly, collect or maintain, an individual’s name in combination with that individual’s driver’s license number or the security number.48


Effective July 1, 2003, California law was amended to require that anyone who conducts business in California and owns or licenses computerized data that includes “personal information,” “shall disclose any breach of the security of the system following discovery or notification of the breach in the security of the data to any resident of California whose unencrypted personal information was, or is reasonably believed to have been, acquired by an unauthorized person.”49 Anyone who maintains such computerized data “shall notify the owner or licensee of the information of any breach of the security of the data . . . .”50 A “breach of the security of the system” means unauthorized access of the computerized data that compromises the security, confidentiality, or integrity of personal information.51

“Personal information” has the same meaning as used in the section which requires a business to have a security policy to protect unauthorized access to personal information.52 Therefore, if the franchisee is contractually prohibited from collecting or maintaining such personal information, the franchisor should be able to avoid the impact of this provision.

4. Disclosure Of Personal Information To Direct Marketers

Effective January 1, 2005, California law was amended to require a business which discloses customer’s personal information to a third party for direct marketing purposes to provide the customer, within 30 days of a request, the name and address of the recipient of the information and details regarding the personal information disclosed. The purpose of the law is to allow customers to “knowledgably choose to opt-in or out-out or choose among businesses that disclose information to third parties for direct marketing purposes on the basis of how protective the business is of consumers’ privacy.”53 Failure to comply with this provision has serious consequences. Not only can the customer obtain actual damages and injunctive relief,

48 Personal information also includes a combination of name and either account number, credit card number or debit card in association with the access code for those accounts or medical information. It is difficult to imagine a circumstance under which that combination of information would be obtained by a franchisee. However, if it is possible, then collecting and maintain “personal information” is likely and the provisions of this section of the law requiring a security policy should be incorporated into the franchise agreement.

49 Id. at § 1798.82(a).

50 Id. at § 1798.82(b).

51 Id. at § 1798.82(d).

52 Id. at § 1798.82(e).

but the customer can also obtain a civil penalty of up to $500 per violation and, for a willful, intentional or reckless violation, a civil penalty of not more than $3,000 per violation.\textsuperscript{54}

This provision of California law will have broad application to franchisors. Suppose the Nevada hotel franchisee collects personal information from California residents who are guests of the hotel and transmits that information to the franchisor. The “personal information” that implicates this provision of the law is information in any one of 27 different categories.\textsuperscript{55} The franchisee is a business and the franchisor is a third party because it is “a separate legal entity” from the franchisee.\textsuperscript{56} The information is disclosed to the franchisor for “direct marketing purposes” if the information is to be used to solicit or induce a purchase of goods or services directly to individuals by means of mail, telephone or electronic mail for personal, family or household purposes.\textsuperscript{57}

The California law provides several exemptions which may be applicable to a franchise relationship. Among the exempt disclosures are disclosures between a business and a third party pursuant to a contract pertaining to “[j]ointly offering a product or service pursuant to a written agreement with the third party that receives the personal information,” but only if (1) the product or service offered is a product or service of and provided by one of the businesses to the agreement, (2) the product or service is jointly offered, endorsed or sponsored by, and clearly and conspicuously identifies for the customer, the businesses that disclose and receive the personal information, and (3) the written agreement provides that the third party that receives the personal information is required to maintain the confidentiality of the information and is prohibited from disclosing or using the information other than to carry out the joint offering or servicing of a product or service that is the subject of the written agreement.\textsuperscript{58} There are other exemptions, but those are not as likely to apply to most franchise relationships.

\textsuperscript{54} Id. at § 1798.84.

\textsuperscript{55} Id. at § 1798.83(e)(6).

\textsuperscript{56} Id. at § 1798.83(e)(8).

\textsuperscript{57} Cal. Civ. Code § 1798.83(e)(2).

\textsuperscript{58} Id. at § 1798.83(d)(1)(E).
Absent an exemption, a franchisee that collects personal information from its customer and then transfers that information to the franchisor must disclose to the customer on request a list of specific personal information which was disclosed and the names and addresses of all of the third parties who received the information.\textsuperscript{59} The franchisee must designate a mailing address, e-mail address or toll free telephone number where a customer can request such information. A franchisee must also (1) inform its employees who have contact with its customers of how customers can obtain the company’s privacy policy, information, (2) state the company’s privacy policy on its website, or (3) make designated addresses or numbers readily available upon request of a customer at every place of business in California where the business or its agents have contact with customers.\textsuperscript{60}

If the franchisor requires its franchisees to convey any personal information the franchisee collects from its customers without implementing appropriate procedures for complying with these provisions of the California law, the franchisee could be enjoined from transmitting any customer information to the franchisor and the franchisor may be held liable by its franchisees for placing them in a position where they are liable without creating the mechanism to avoid liability.

\textsuperscript{59} Id. at § 1798.83(a).

\textsuperscript{60} Id. at § 1798.83(b).
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