As I write this, my first Message from the Chair column, I’m recovering from a bit of jet lag after spending a few glorious days taking long walks in the English countryside with my wife (Kelly) and two teenage boys (Ben and Abe). I hope each of you have also had an opportunity to refresh a bit at some point over the summer and are looking forward to new beginnings this fall.

I very much look forward to serving as Chair of the Forum over the next two years and interacting more with all of you. I, again, want to thank Eric Karp for his leadership as Forum Chair for the past two years, and thank him in advance for all the good guidance that I know he will provide to me in his role as immediate past Chair.

At some point in the autumn of each year (generally in early October when the average high temperatures in Dallas finally fall below 95!), I fondly (and somewhat nostalgically) think back to Philadelphia in 1998. I was fresh out of law school and on the first of many business trips. But this one was special: it was the first annual Forum on Franchising meeting that I would attend. The partners overseeing the franchise group in which I practiced at the time had the good judgment and foresight to send me to the Forum (and, in particular, the Fundamentals of Franchising) as a (very) young lawyer.

What I did not fully appreciate then, but that I learned over time, was that I was being exposed to the best and brightest in franchise law. I did recognize that these were people who cared passionately about our practice area, were enthusiastic about sharing their knowledge, and wanted to get to know me—this 26 year old kid! The spirit of the Forum that I felt in Philadelphia in 1998 is alive and well in the Forum of 2019.

In fact, our annual meetings are bigger (we regularly have 800+ attendees now) and offer more educational and networking opportunities than ever for all levels of lawyer and other franchise professionals. That said, the Forum

Continued on page 19
Table of Contents

1 Message from the Chair
Will K. Woods

3 Facts and Context Mean EVERYTHING in Dealer Termination Disputes in Puerto Rico
Ricardo F. Casellas

6 The Intersection of Franchising and Secured Lending: Uniform Commercial Code Section 9-408
Jordan Myers

9 Franchise Arbitrations: Selected Best Practices
Peter Silverman

14 Feeling Exposed? How to Use Franchise Applications to Close Gaps in Arbitration Coverage for Section 1981 Cases
Matthew S. DeAntonio, Jennawe M. Hughes, and Ari N. Stern

17 Member Spotlight
Paul F. Woody

19 Message from the Editor in Chief
Karen C. Marchiano
Facts and Context Mean EVERYTHING in Dealer Termination Disputes in Puerto Rico

By Ricardo F. Casellas, Casellas Alcover & Burgos, P.S.C.

When litigating dealer termination disputes in states or territories with strong dealer-protection laws like Puerto Rico, the totality of the facts and circumstances matters. Facts that at first glance might appear to be good cause for termination—such as a dealer’s breach of payment terms—may not in fact be good cause for termination under Puerto Rico or similar laws when the entire situation is examined in greater detail and the statutes are scrutinized. Such is the lesson from Puerto Rico Hospital Supply, Inc. v. Johnson & Johnson International, International Center for Dispute Resolution of the American Arbitration Association Case No. 01-17-0007-4506, where an arbitration panel found that Johnson & Johnson International (J&JI) did not have just cause under Puerto Rico law to terminate Puerto Rico Hospital Supply Group, Inc.’s (PRHS’s) dealership despite PRHS’s breach of 90-day payment terms.

The PRHS arbitration teaches parties and counsel to investigate and not take proffered reasons at face value when litigating in Puerto Rico or states with similar laws, where pretextual reasons may not provide good cause for termination. For example, counsel should ask whether preexisting financial motivations, the manufacturer’s conduct in analogous situations, or other facts suggest that the business reason the manufacturer ostensibly gives for a termination is a pretext. Similarly, both sides should be aware of what documents are available in discovery to potentially prove pretext. In the PRHS arbitration, the following documents were critical in proving pretext: internal plans to bypass PRHS that were devised prior to PRHS falling behind in payment; a J&JI manager job evaluation where she took credit for implementing a “PRHS legal strategy” to move the organization from an indirect model to a direct model; J&JI’s Puerto Rico division’s financial statements showing a loss that needed to be overcome; and a J&JI rejection of PRHS’s offer prior to termination to guarantee payment to J&JI through a payment and performance bond which would have operated like cash.

Moreover, statutes similar to Puerto Rico’s dealership law may void contractual provisions that might otherwise provide just cause for termination. For example, under Puerto Rico law, to provide just cause for termination, a purportedly breached provision may be required to be reasonable and to adjust to market conditions in the territory at relevant times. In the PRHS arbitration, the 90-day payment terms were viewed as “rules of conduct” and thus subject to § 278a-1(c)’s requirement that they be adjusted to the realities of the Puerto Rican market at the time of the violation. Because they had not been, they were invalid. Counsel are well-advised to scrutinize dealer-protection statutes for such exceptions.

Facts Underlying PRHS Arbitration

PRHS is one of Puerto Rico’s oldest and largest distributors of medical devices and products. After 1964 until 2017, PRHS sold and distributed J&JI’s branded sutures and medical devices used in surgical procedures by hospitals and other medical providers throughout Puerto Rico.

Since approximately 2007, Puerto Rico’s economy has slumped, with its government financially collapsing. Private and public hospitals have suffered from this economic downturn, and from catastrophic damages and business interruptions caused by Hurricanes Irma and María in 2017.

In 2015, the liquidity of hospitals grew tighter, aggravating delays in hospitals’ payments to their suppliers, including to PRHS. While the days sales outstanding of PRHS’s invoices to hospitals increased to roughly 183 days on average (some public hospitals took over 300 days to pay), PRHS’s distribution contracts with J&JI all had 90-day payment terms. During 2016, PRHS started falling behind in its payments to J&JI, but continued making partial payments of millions of dollars.
In September 2017, J&JI sent a notice to PRHS unilaterally terminating all of its exclusive agreements with PRHS, ostensibly for lack of payment, but informing PRHS that J&JI had decided not to terminate one agreement between the parties (the non-exclusive agreement that had a mandatory arbitration provision) even though PRHS had been behind in its payments for products sold under all the agreements. (The exclusive agreements did not have a mandatory arbitration provision.) The termination of the exclusive contracts became effective one day after Hurricane María made landfall over Puerto Rico.

By the effective termination date in September 2017, J&JI also took over the direct sale and distribution to customers of all the products previously sold and distributed by PRHS under all the contracts, including the non-exclusive contract. In October 2017, J&JI informed PRHS that PRHS was not authorized to place any purchase orders for any products of J&J’s brands and demanded the return of all inventory. In November 2017, PRHS complied and returned all of its inventory of J&J’s products which J&JI later resold to customers.

The PRHS Arbitration
PRHS then filed a Demand for Arbitration with the AAA alleging a claim under Law 75 (PR. Laws Ann. tit. 10, § 278) for termination without just cause of the non-exclusive agreement and requesting damages, fees and costs. J&JI counterclaimed for collection of monies which allegedly exceeded $540,000.

PRHS also filed a separate action in federal court in Puerto Rico under Law 75 for termination of the exclusive contracts, Puerto Rico Hospital Supply, Inc. v. Johnson & Johnson, International, Case No. 3:17-cv-02281-DRD (D.P.R. Nov. 6, 2017) which was subsequently stayed.

After extensive discovery and seven days of evidentiary hearings, a three-member Panel (including one former federal district court judge) rendered a final award on May 2, 2019. In the 63-page majority decision, with one panelist concurring and dissenting in part, the Panel determined that J&JI had terminated the non-exclusive agreement without just cause in violation of Law 75. The Panel awarded PRHS five years of lost profits, the cost of the returned inventory, AAA fees, the pro rata share of fees it paid for panel compensation, attorney’s and expert witness fees as the prevailing party under Law 75 (PR. Laws Ann. tit. 10, § 278 et seq.), and costs and interest at the annual rate of 6.25%, for a sum exceeding $1.1 million. As to the counterclaim, the Panel determined that J&JI failed to prove the existence and exact amount of a debt due for the non-exclusive agreement product sales. J&JI also could not rebut PRHS’s showing disputing the invoices and proving that certain credits due on the account were not applied and exceeded the amount of the invoices. Thus, the Panel unanimously concluded that J&JI had failed to meet its burden under Puerto Rico law to prove the existence of the debt or its amount and dismissed the counterclaim with prejudice.

Termination Without A Termination Notice
The Panel determined that, although the manufacturer may have proclaimed in writing that it was not terminating the non-exclusive agreement, the manufacturer’s subsequent actions and course of conduct proved its intent to refuse to deal and effectuated a termination of all the contracts. J&JI prohibited PRHS from honoring any purchase orders from its customers for the sale of any J&J products, prohibited PRHS from using J&JI’s trademarks for marketing purposes, ordered PRHS to return all products in inventory, and later sold the inventory directly to PRHS’s former customers. The Panel held that J&JI’s “intention in 2017 was simply to terminate all commercial relations with PRHS and move from an indirect to a direct sales strategy, completely cutting out PRHS from the equation.” (Award at 31).

Breaches of 90-day Payment Term Were Pretext and Not Just Cause For Termination
Once PRHS had proven a termination or impairment of the agreement, the burden shifted to J&JI to prove just cause. Newell P.R., Ltd., 20 F.3d at 22; PR. Laws Ann. tit. 10, §§ 278, 278c. J&JI needed to rebut a legal presumption of lack of just cause from having sold the products previously handled by the distributor. PR. Laws Ann. tit. 10, 278a-1(b)(1). Whether or not there was just cause for termination was a fact-intensive question (see, e.g., Newell P.R., Ltd. v. Rubbermaid Inc., 20 F.3d 15, 22-23 (1st Cir. 1994); Yacht Caribe Corp. v. Carver Yacht LLC, 270 F. Supp. 3d 547, 552-554 (D.P.R. 2017)). The Panel heard live witness testimony and received documentary evidence. J&JI argued that PRHS’s breaches of the 90-day payment term, without more, were just cause under Law 75. The arbitrators disagreed.

The Panel observed that, under Puerto Rico law, lack of timely or complete payments is not just cause without considering the terms of the agreement, the essentiality of the payment obligations, the materiality of the breaches, and the conduct of the parties.
Payment Terms Needed to Be Adjusted to Realities of Puerto Rican Market

The Panel also decided a novel issue of Puerto Rico law which should be relevant to any manufacturer or supplier considering the termination of a dealer’s contract for lack of payment in the context of adverse economic or market conditions. Puerto Rico Law 75 has a provision that any “rules of conduct” or distribution quotas or goals in a dealer’s contract must adjust to the realities of the Puerto Rico market at the relevant moment of the dealer’s nonperformance, or else are unenforceable.

§ 278a-1(c) of Law 75 provides: “The violation or nonperformance by the dealer of any provision included in the dealer’s contract fixing rules of conduct or distribution quotas or goals because it does not adjust to the realities of the Puerto Rican market at the time of the violation or nonperformance by the dealer shall not be deemed just cause. The burden of proof to show the reasonableness of the rule of conduct or of the quota or goal fixed shall rest on the principal or grantor.”

From the plain language, context, and statutory history, the Panel concluded that the prohibition in this 1988 amendment of Law 75 was not limited to performance quotas or goals set in a distribution contract, but also applied to payment terms, which the Panel viewed as rules of conduct. Because J&JI failed to present any evidence that the 90-day payment terms adjusted to the realities of the relevant health care market in Puerto Rico during 2016-2017, the Panel credited PRHS’s expert testimony that the payment terms were unreasonable, and therefore, null and void under Law 75.

PRHS has filed in federal court (D.P.R. Case No. 17-cv-1405-FAB) a motion to confirm the award under the Federal Arbitration Act. The award is part of the judicial record in that action. Subsequently, J&JI moved to vacate the award. As of the drafting of this article on August 13, 2019, enforcement proceedings are ongoing.

Note: The author is lead counsel for the distributor in the AAA arbitration subject of this article and related federal litigation.
The Intersection of Franchising and Secured Lending: Uniform Commercial Code Section 9-408

By Jordan Myers, Alston & Bird LLP

Access to capital is critically important for franchisees to succeed and grow. Particularly in recent years, there has been no shortage of lenders willing to provide financing to franchisees. As the loan documentation memorializing franchise finance transactions becomes more complex, franchisees and franchisors need to understand the scope of the lender’s proposed collateral and the nuances of applicable secured transactions law. More specifically, the Uniform Commercial Code may alter the effect of certain collateral restrictions set forth in most franchise agreements and limit the lender’s remedies related to such collateral.

Collateral Restrictions in Franchise Agreements

Franchisors desire to control the selection of operators of their franchised units. Therefore, franchise agreements typically prohibit at least two collateral protections that are ordinarily available to lenders in a secured lending transaction: (1) a security interest in the equity of the franchisee borrower known as an “equity pledge,” and (2) a security interest in the franchise agreement itself. Equity pledges protect lenders by allowing a lender to foreclose on the ownership interests of its borrower upon an event of default, and to sell the borrower’s business as a going concern in a foreclosure sale. Security interests in material contracts such as franchise agreements provide lenders with valuable contractual rights in the event of a borrower’s default. Franchise finance presents a unique credit risk to lenders because the value of the franchisee’s enterprise is dependent upon the rights under the franchise agreement (i.e., the right to use the franchisor’s intellectual property and related rights), but the lender is generally unable to obtain a customary “all assets” lien as a result of the restrictions in the franchise agreement.

Equity Pledge

Many lenders are willing to forego the protections of an equity pledge in a franchise finance transaction. Conversely, some franchisors permit the equity pledge, subject to many restrictions, one of which is a requirement that the equity purchaser is satisfactory to the franchisor. In that circumstance, the equity pledge of a franchisee entity may be of limited utility compared with the equity pledge in a non-franchise finance transaction because the franchisor’s consent right significantly limits the pool of potential purchasers.

Security Interest in the Franchise Agreement

The analysis of the lender’s security interest in the franchise agreement is more nuanced, and requires an understanding of Section 9-408 of the Uniform Commercial Code, which governs secured transactions. Section 9-408 balances the desire of the franchisor to protect its brand with the need of the franchisee to obtain credit. First, Section 9-408 benefits the franchisee (and its lender) by invalidating the provision in the franchise agreement that prohibits, or requires the franchisor’s consent to grant, a security interest in the franchise agreement. See U.C.C. § 9-408(a). Specifically, clause (a) states:

[A] term in . . . an agreement between [a franchisor] and a [franchisee] which relates to a . . . general intangible, including a . . . franchise, and which term prohibits, restricts, or requires the consent of the . . . franchisor to, the assignment or transfer of, or creation, attachment, or perfection of a security interest in, the . . . general intangible, is ineffective to the extent that the term:

(1) would impair the creation, attachment, or perfection of a security interest; or
(2) provides that the assignment or
transfer or the creation, attachment, or perfection of the security interest may give rise to a default, breach, right of recoupment, claim, defense, termination, right of termination, or remedy under the . . . general intangible.

See id. Thus, by itself, the franchisee’s grant to a lender of a security interest in the franchise agreement does not establish an enforceable breach under such franchise agreement, notwithstanding any prohibitions to the contrary contained therein.

But, in turn, Section 9-408 also protects the franchisor by providing that the lender’s security interest in the franchise agreement:

1) is not enforceable against [the franchisor];
2) does not impose a duty or obligation on [the franchisor];
3) does not require [the franchisor] to recognize the security interest, pay or render performance to the secured party, or accept payment or performance from the secured party;
4) does not entitle the secured party to use or assign [the franchisee’s] rights under the . . . general intangible, including any related information or materials furnished to [the franchisee] in the transaction giving rise to the . . . general intangible;
5) does not entitle the secured party to use, assign, possess, or have access to any trade secrets or confidential information of [the franchisor]; and
6) does not entitle the secured party to enforce the security interest in the . . . general intangible.

See U.C.C. § 9-408(d). As clarified in the comments to Section 9-408, the effect of these provisions is that the lender cannot foreclose upon the rights under the franchise agreement and “step into the shoes” of the franchisee to operate the business (or assign those rights to a third party), but the lender will retain a lien on the proceeds of the franchise agreement upon a sale thereof. See U.C.C. § 9-408 (cmts. 7–8). Thus, while the lender’s ability to enforce unilateral remedies with respect to the franchise agreement is limited, the lender will still maintain a claim to the proceeds of a sale of the franchisee’s business that has priority over other creditors of the franchisee and the franchisee itself.

**Application to Collateral Documentation**

The manner in which the granting clause in the security agreement is drafted is of critical importance to the lender. While a cursory review of the collateral prohibitions set forth in the franchise agreement may lead the franchisee and lender to exclude the franchise agreement from the scope of the security interest in its entirety, Section 9-408 suggests a more nuanced approach. Instead of excluding the franchise agreement entirely from the collateral grant, lenders are well-served by relying on the conventional “excluded collateral” language contained in most security agreements. The excluded collateral definition sets forth a list of assets that are excluded from the scope of the lender’s security interest. The following collateral grant exception is a common prong in a definition of “excluded collateral”:

any permit or license or any contractual obligation entered into by any borrower that prohibits or requires the consent of any person other than the borrower and its affiliates that has not been obtained as a condition to the creation by the grantor of a lien on any right, title or interest in such permit, license or contractual obligation or any equity interests related thereto, but only to the extent, and for as long as, such prohibition or requirement is not terminated, waived or rendered unenforceable or otherwise deemed ineffective by the UCC, any other law or any principle of equity.

This language has the effect of excluding from the collateral any contract for which the consent of the contract counterparty is required (e.g., the franchisor under the franchise agreement), but only to the extent such prohibition or requirement is not deemed ineffective by the Uniform Commercial Code. Thus, such language gives effect to Section 9-408, its related benefits in favor of the franchisee and its lender (including retaining a lien on the proceeds of the sale of the franchise agreement), and its protections for the franchisor, notwithstanding the restrictions in the franchise agreement.
Risk to the Lender
Excluding the franchise agreement from the scope of the lender’s security interest entirely may result in adverse consequences for the lender. This risk was highlighted in a recent franchisee bankruptcy case. On May 8, 2018, RMH Franchise Holdings, Inc., one of the largest franchisees in the Applebee’s system, and certain of its affiliates, filed for bankruptcy protection. The unsecured creditors committee, which represents the interests of unsecured creditors in a bankruptcy case, realized that the lender acknowledged in the loan documents that the franchise agreements were excluded from the scope of its security interests. Based on that acknowledgment, the unsecured creditors committee argued that the franchise agreements, which comprised a significant portion of the value of the debtors’ business, as well as any proceeds of the franchise agreements, were not part of the lender’s collateral and any recovery should be shared among the unsecured creditors. See In re RMH Franchise Holdings, Inc., et al., Case No. 18-11092 (Bankr. Del., August 15, 2018) (Doc. 455). While the bankruptcy court did not ultimately rule on the issue (and there is a dearth of case law on the application of Section 9-408 in the franchise context), the case highlights the risk to the lender in entirely excluding the franchise agreement from the scope of its security interest. At the very least, the unsecured creditors committee may use such language to negotiate a payout in the event of a sale of the assets of the franchisee, or a more favorable plan of reorganization.

While the drafting of the security interest to give effect to Section 9-408 may be of critical importance to the lender, this approach should not adversely impact either the franchisor or franchisee. The franchisor is not harmed because the lender cannot enforce the security interest nor use or assign the franchisee’s rights under the franchise agreement due to the restrictions set forth in Section 9-408(d). The franchisee is not harmed because the competing drafting approaches likely only impact matters outside the scope of its relationship with the franchisor—that is, the distribution of proceeds among secured and unsecured creditors in a sale. Precise drafting in this regard benefits the franchisee and franchisor by providing greater certainty to the lender regarding potential outcomes, which encourages lenders to continue to provide critical liquidity to the franchise industry.

Tri-Party Agreements
In addition to the security agreement, franchisors, franchisees and lenders should also consider the impact of Section 9-408 on tri-party agreements, if pursued by the lender. The tri-party agreement is an agreement among the franchisor, the franchisee and the lender that clarifies each party’s rights to exercise remedies under the loan documents and franchise documents. A lender typically seeks the following rights in a tri-party agreement: (1) an acknowledgment that its security interest attaches to the franchise agreement and related assets; (2) notice and opportunity to cure any default by the franchisee under the franchise agreement; and (3) upon an event of default under the loan documentation, a framework for working with the franchisor to convey the assets of the franchisee to a successor franchisor-approved operator. In drafting such agreements, the parties should clearly state the scope of collateral and remedies available to the lender, and understand the way in which those provisions may be impacted by Section 9-408.

Conclusion
The explosive growth of the number of franchise finance lenders has led to disparate treatment in documentation on a variety of issues, including the scope of the lender’s security interests. A proper understanding of Section 9-408 of the Uniform Commercial Code should create greater uniformity in documentation while, at the same time, not exposing lenders, franchisors and franchisees to undue risk.
Franchise Arbitration: Selected Best Practices

By Peter Silverman, Shumaker, Loop & Kendrick LLP

For thirty-two years, I have been an arbitrator and franchise lawyer. I have seen (and made) many mistakes, some of them repeatedly, and I have seen ways arbitration could be handled better than it is usually done. Based on lessons learned and preferences developed, I would like to share a few thoughts on best practices about drafting the arbitration clause, choosing the arbitrator, and making your case at the hearing.

A. DRAFTING THE ARBITRATION CLAUSE

1. Confidentiality
Under AAA and JAMS rules, non-parties do not have the right to obtain access to the proceedings or pleadings from AAA/JAMS staff or arbitrators, and arbitrators have authority to enter confidentiality orders to govern discovery and admission of evidence at hearings. (AAA Statement of Ethical Principles; AAA Rules 23(a), P(2)(x); JAMS Rule 26(a), (b)). However, parties have no obligation of confidentiality regarding the arbitration. If you want more confidentiality, include that in your clause. The AAA Clause Builder (https://bit.ly/2DfVAzH) suggests: “Except as may be required by law, neither a party nor an arbitrator may disclose the existence, content, or results of any arbitration hereunder without the prior consent of both parties.” The exception for legally-mandated disclosures should be used so as to cover the required FDD disclosures. Another confidentiality issue that arises when, in a later case, a party makes a discovery request for discovery or pleadings in the arbitration. Courts tend to be skeptical of the relevance of such requests, but do not consider themselves bound by the parties’ prior arbitration confidentiality agreement.

2. Who decides?
The law is in flux as to who—an arbitrator or the court—should decide whether a matter is arbitrable. If you want to have the arbitrator decide this, say so in your clause. See, e.g., Schein, Inc. v. Archer & White Sales, Inc., 139 S.Ct. 524, 2019 U.S. LEXIS 566 (2019) (parties to a contract may agree to have an arbitrator decide not only the merits of a particular dispute, but also gateway questions of arbitrability). Here is language I have used: “Any dispute arising out of or in connection with this arbitration provision, including any question regarding its existence, validity, scope, or termination, shall be decided by arbitration.”

3. Speed
If you want to resolve your dispute quickly, specify a time period. For example: “Absent exceptional circumstances or both parties’ agreement, any hearing pursuant to this clause shall be held within six months of the filing of the demand.” Considering that complete cases are routinely prepared for preliminary-injunction hearings and tried in two-three weeks, it is reasonable to specify a six-month deadline for arbitration.

4. Discovery limits
Because different kinds of cases call for different levels of discovery, I think it is a mistake to put specific limits on discovery into your arbitration clause. When you are first entering a franchise agreement, you do not know what kind of dispute, if any, will arise. The best way to make sure that discovery will be proportional to the dispute that actually arises is to choose a good arbitrator. Good arbitrators have the professional judgment to ensure speed and economy while allowing for reasonable discovery tailored to the issues and proportional to what is at stake.

5. Arbitrator qualifications
The AAA has a large, complex case panel that is limited to its most experienced arbitrators. If you want to choose from this panel, state in your clause: “The arbitrator(s) shall be selected from the AAA’s large, complex case panel.” You do not need a similar clause for JAMS because all its arbitrators are full-time and either very experienced arbitrators or retired trial judges.

If you want arbitrators knowledgeable in franchise law, say so in your clause. This is not
always a great filter, though, as many arbitrators will list franchise experience based on exposure in just a few cases, and the AAA may include anyone listing that experience. But there will be many experienced practitioners on the list as well.

6. One or three arbitrators
One of arbitration’s benefits is that you can select an exceptional individual to be your arbitrator instead of being stuck with the judge you arbitrarily draw. You can do your homework on experienced arbitrators to find out their substantive or procedural leanings (including discovery limits), and whether they are open-minded.

I think one arbitrator—like the one judge in a trial court—is usually enough. Still, no matter how much due diligence you do, selecting a single arbitrator means you are relying on one person and there is a chance of getting an opinion significantly outside the bounds of what you reasonably expected. And, unlike court proceedings, there is no meaningful opportunity to overturn an arbitrator’s decision.

Having sat on a number of three-arbitrator panels with outstanding colleagues, I have seen how differently top professionals can view the same evidence and arguments.

Three-arbitrator panels reduce the risk of an anomalous decision. The panelists discuss the evidence and their conclusions at length. Where their views differ, they challenge each other. Principled disagreement is the rule, not the exception. The chair frequently seeks to harmonize views to reach a consensus award without a dissent. This results in maverick views being tempered, increasing the likelihood of a reasonably foreseeable award.

The downside to three-arbitrator panels is that they cost more than single-arbitrator arbitrations—by a factor of five in some cases according to the AAA. (See http://go adr.org/Streamlined_Panel_Option.html.). That is because the parties are not only paying three arbitrators, they are paying for the three to confer among themselves and reach consensus on all interim matters and the final award. Three-arbitrator panels also take longer because of the need to accommodate more people’s calendars.

If you want the advantages of a three-arbitrator panel without all the costs, consider specifying one arbitrator for cases up to a certain dollar amount, and three arbitrators for an amount over that. And for cases where you do specify three arbitrators, consider some form of the AAA’s streamlined three-arbitrator panel procedures. There are several options based on the general principle that pre-hearing matters will be decided by the chair, while the final decision will be made by the full panel. Id.

B. CHOOSING THE ARBITRATOR(S)

1. Franchise experience
It is smart to pick an arbitrator with significant franchise experience. There is a good deal of custom and accepted practice in the franchise sector, and with an arbitrator who has significant experience in the field, you do not need a franchising expert to explain that custom and practice. You can, for example, dive right into a case on financial performance representations without explaining the original impetus for franchise legislation, the thinking behind Item 19, or the changing terminology.

For a long time, most arbitrators who were experienced in franchising came from firms that represent only franchisors, and franchisee counsel were concerned that these arbitrators’ views reflected their clients’ interests. This has changed. A number of franchisee-side lawyers now are on panels. But the biggest change is the growth in the number of lawyers who represent both franchisors and franchisees, a number of whom are on panels as well. Also, the franchise bar is small enough that you can get a good sense of which arbitrators would be scrupulously open-minded regardless of whether they have represented primarily franchisors or franchisees in their practice. Many of the panel members who represent primarily franchisors or franchisees as advocates are fair to both sides as arbitrators.

2. Ask, ask, ask
If you are selecting among arbitrators active in franchising and you do not have personal knowledge about them, e-mail colleagues and ask about the arbitrators. Reach out especially to those in bigger firms; if they have not appeared before a given arbitrator, one of their colleagues may have. If the prospective arbitrators are from
a certain geographical area, e-mail your Forum colleagues in that area for insight.

The AAA offers an enhanced arbitrator selection process for large complex cases that allows pre-screening for conflicts and qualifications, requests for supplemental description of arbitrators’ experience, and oral or written interviews of candidates. If you have any concerns regarding potential arbitrators, use these procedures.

If you suspect that some arbitrators may be inclined to side with a franchisor over a franchisee because the franchisor is more likely to hire that arbitrator again, you can investigate. Arbitrators are required to disclose whether they have ruled on a case involving either party or its counsel, but the optional procedures might allow you to ask how many cases they have ruled on between any franchisor and a franchisee. You could also ask for the name of counsel in those cases, and you could then interview the counsel. (Asking for counsel names is not yet an approved process, but I encourage you to ask for it if you want it.)

3. Choosing a wing arbitrator
In clauses that provide for each side’s appointing a wing arbitrator, the first step is to determine whether the arbitrator is required to be neutral. (It is rare for a clause to provide for non-neutral wings, and the clause must do so explicitly.) Once you determine that issue, you are entitled to interview prospective wing arbitrators. The scope of the discussion should be governed by Canon III of the Code of Ethics for Arbitrators in Commercial Disputes (ABA 2004). Basically, you can discuss parties, witnesses, counsel, the general nature of the case but not its merits, and selection of the chair. (For further description, see P. Silverman, Party-Appointed Arbitrators: Ethical Concerns, The Franchise Lawyer, Spring 2014, at 6.)

Look for someone who is open-minded about the position you will be advocating, but who also has the integrity to vote against you. If your evidence and arguments persuade your wing, you want your wing to bring along the other two arbitrators. Wings who lack integrity or are clearly biased on how the law should be applied will have a hard time convincing the other two arbitrators. Along the same lines, look for a wing who is a decent person and a persuasive advocate. The panel spends a lot of time together discussing the case and exchanging views in writing. Jerks do not fare well in that environment.

4. Your case administrator is your friend
In an administered arbitration, there will be an assigned case administrator. These are very knowledgeable people who also have access to superiors for questions they cannot answer themselves. If you have any questions about the process (even after selection of the arbitrator), call or e-mail the administrator.

C. THE HEARING

1. Speed and economy
For all experienced arbitrators, the watchwords of arbitration have become speed and economy. Arbitrators will welcome parties jointly proposing a case schedule that is swift and economical. If the parties cannot agree on one, and your client wants speed and economy, press for that with the arbitrator. While good arbitrators will want to be fair to both sides, they should be far more favorable to requests for speed and economy than a court would be.

2. You can ask for early views and questions
As part of the focus on speed and economy, the modern trend is that arbitrators should be open to helping the parties resolve the dispute voluntarily. One way to do this is for the parties, at some point, to ask arbitrators to share their initial impressions of the case and the questions on which they are focused.

Arbitrators have traditionally disfavored offering early views, as it is inconsistent with the idea that decision makers should keep an open mind until all the evidence is in. But the reality is that arbitrators have initial impressions, and it may help parties settle if the arbitrators are willing to share these views. Also, even absent settlement, learning the arbitrators’ initial views and questions helps the parties focus on the issues that will persuade the arbitrators. And if the arbitrators do not mention an issue that you think is important to your client’s case, that may prompt you to put in the work it will take to show the arbitrators that that issue is important.
A more aggressive approach would be to ask the arbitrator to try to mediate the case, and then to serve as the arbitrator if the parties do not reach agreement. (You could also ask this of one member of a three-member panel.) Traditionally, arbitrators disfavored this approach because it requires changing hats and there is a concern that parties will not be forthcoming in mediation if they know the mediator may become the arbitrator. But the modern trend is to be more open to serving in this dual capacity.

3. The CCA Guide is your friend
Much of arbitration procedure is governed by custom, and it is to your advantage to know the generally-accepted customs. The College of Commercial Arbitrator publishes a Guide to Best Practices containing chapters written by highly-regarded College arbitrators. Regardless of whether your arbitrator has been admitted to the College, the Guide is considered a thoughtful discussion of best practices that you can cite persuasively.

4. Presenting the facts
Any fool can present facts in chronological order, using simple declarative sentences, and avoiding adverbs and adjectives. Be a fool. Plus if you prepare a one-page, neutral, easy-to-read chronological time line, you may well see the arbitrators keep it in front of them every day of the hearing.

5. Third-party subpoenas
Compelling third parties to testify is difficult and takes time, and the requirements differ by Circuit. If you expect to need documents or testimony from an uncooperative witness, request your subpoenas right away so you have time to seek court assistance to compel the testimony or documents.

6. Deposition testimony
Generally, there should be no reason to read deposition testimony in an arbitration hearing unless there is part of the transcript that is essential to your case. Instead, consider asking the arbitrators if you can give a short summary at the point in the hearing when you would otherwise submit the transcript to be read or viewed. You would say something like: “This is where Jones’ deposition testimony becomes pertinent, and we’ve submitted it for you to read. Jones worked for the franchisor, but is with a new employer now. He provides the detail on how the franchisor calculated its Item 19 by cherry-picking the pool of franchisees from which it derived its averages.”

Along similar lines, if you have a number of live witnesses, you may want to work out with the arbitrators that before you start questioning a witness, you can give a short summary of the witness’s expected testimony and how it fits into the case.

7. Damages
Proving damages in a court case is difficult, in part, because of the evidentiary burdens related to the data on which the damages witness is relying. Because arbitration is usually not governed by the rules of evidence, it is much easier to admit and use the underlying data in arbitration.

Do not take this too far, however. Arbitrators still need to know the underlying data and be comfortable that it is reliable. The data you give them should be stipulated to. Make sure it is easily accessible and organized because arbitrators often need to go back through it independently to see how it aligns with their ruling on the substantive legal issues.

Do not limit your damages case to the result that should follow if the arbitrators find for you on all your claims and disputed factual issues. Give the arbitrators guidance on how damages would differ if they do not accept every part of your case. If the evidence is strong enough, you can ask the panel to trim your damages request based on rough justice, but offer the panel plenty of data and guidance so they are not speculating.

8. Ask for post-hearing guidance on important facts and issues
Ask your arbitrators to give you guidance for closing argument or post-hearing briefing on the factual and legal issues they are focused on. Urge them to be as specific as they can be. This allows you to focus on what will be most persuasive in winning your case or highlighting something that the arbitrators hadn’t yet deemed important.

9. Criticizing opposing counsel
Don’t. Stick to the issues. Personal criticism usually turns into a WWE wrestling match, and arbitrators do not want to referee attorney brawls.
The only exception is if the behavior is so egregious as to call for severe sanctions. Beware, though, if you call for severe sanctions and do not have strong, near-uncontestable support, you will strongly weaken your credibility.

10. Rules of evidence
The common practice in arbitration is not to apply the rules of evidence unless the arbitration clause requires it. But do not assume that will be the practice at the hearing. AAA rule 34(a) provides that “[c]onformity to legal rules of evidence shall not be necessary.” So ask arbitrators how they will handle evidentiary objections at the hearing. And, if you want the arbitrators to apply the rules, try to persuade them to do so.

If the arbitrators will not apply the rules, save your objections for matters that should be excluded based on general notions of justice. Arbitrators are reluctant to exclude evidence because one ground for vacating an award is that the arbitrators were “guilty of misconduct… in refusing to hear evidence pertinent and material to the controversy.” Thus prudent arbitrators may simply accept the evidence for what it’s worth. Nonetheless, raising the objection will give you the chance to make your point as to why the evidence should be disregarded.

***

Two last comments: First, arbitration clauses in franchise agreements may be up to twenty years old and outdated. Or, regardless of when the clause was drafted, it may not provide for the best procedure suited to your dispute. If that is the case, ask your opposing counsel to consider changing the procedure.

Second, and the best suggestion I have to offer, if you are new to arbitration or even if you are experienced and have questions or concerns, reach out to other Forum members. This is an incredible group of lawyers who regularly offer help to others—you just need to ask.
Feeling Exposed? How to Use Franchise Applications to Close Gaps in Arbitration Coverage for Section 1981 Cases

By Ari N. Stern, O’Hagan Meyer, Matthew S. DeAntonio, Bradley Arant Boult Cummings LLP, and Jennawe M. Hughes, O’Hagan Meyer

I. Introduction.

The legal community holds mixed views on the relative merits of litigation vs. arbitration. But for parties who favor arbitration, it may be distressing to learn that there are gaps in even the best-drafted arbitration clauses in franchise agreements. One such gap occurs where the dispute involves the franchisor’s refusal to grant a franchise, which may give rise to Section 1981 race discrimination claims or other claims. In this scenario, the prospect never signs the franchise agreement, so the accompanying arbitration clause is of no use.

To guard against this risk, franchisors may consider requiring prospects to submit a franchise application, containing a binding arbitration clause, as a condition to entering into negotiations for the sale of the franchise. That is precisely what happened in Doctor’s Associates, Inc. v. Alemayehu, 934 F.3d 245 (2d Cir. 2019), where the franchisor (Subway) moved to compel arbitration of a Section 1981 claim based on such an application.

But this approach is not fail-safe. To be an enforceable agreement, the application must be supported by valid consideration. Furthermore, to comply with the Federal Trade Commission’s (FTC) Franchise Rule and state franchise laws, the application cannot be provided too early in the process—instead, the prospect must receive a Franchise Disclosure Document (FDD) (and the franchisor must be registered in the relevant state) before the applicant signs the application.

While there is no perfect solution, when done properly, franchisors can use applications to narrow the gap in arbitration coverage and increase the likelihood that they can resolve pre-franchise agreement disputes in arbitration.

II. Despite the Inclusion of Mandatory Arbitration Provisions, Franchisors May Still Be Forced to Litigate Section 1981 Claims in Court.

a. Background on Section 1981.

Congress passed Section 1981 in the aftermath of the Civil War. It states that “[a]ll persons . . . shall have the same right . . . to make and enforce contracts . . . as is enjoyed by white citizens.” 42 U.S.C. § 1981(a). The statute defines “make and enforce contracts” broadly to include “the making, performance, modification, and termination of contracts, and the enjoyment of all benefits, privileges, terms, and conditions of the contractual relationship.” Id. § 1981(b). It prohibits discrimination on the basis of race, which may include ancestry or ethnicity, See St. Francis Coll. v. Al-Khazraji, 481 U.S. 604, 613 (1987).

Every franchise agreement is a contract, and Section 1981 therefore governs the making of the franchise agreement. While franchisors may have legitimate business reasons for awarding franchises to some but not others, race discrimination has no place in the franchise industry. Yet Section 1981 cases are prevalent. See Iris Figueroa Rosario, Section 1981: A Risk Still Alive and Kicking in Franchising, The Franchise Lawyer, Fall 2015, at 5. Prospective franchisees have turned to Section 1981 to seek relief when a franchisor refuses to grant a franchise for discriminatory reasons.

For example, in Harper v. BP Exploration & Oil Co., 896 F. Supp. 743, 746 (M.D. Tenn. 1995), aff’d in part, reversed in part on other grounds, 134 F.3d 371 (6th Cir. 1998), a black applicant...
who already owned a franchise brought a Section 1981 claim against the franchisor. The applicant alleged that the franchisor awarded two additional locations to white applicants, rather than him, on account of his race. *Id.* At a bench trial, the applicant successfully proved discrimination by showing that he consistently received higher performance evaluations than the white applicant who received the first additional location, while the white applicant who received the second additional location had never worked in the petroleum industry before. *Id.* at 750. The franchisor’s purported non-discriminatory reason—that the franchisee was not a “quality dealer”—was pretext given that the franchisee had complied with the terms of his contract, had consistently received good performance reviews, and had not been terminated like other franchisees who were not “quality dealers.” *Id.* The franchisee was awarded $350,000 in punitive damages and $280,287 (reduced to $97,888 on appeal) in compensatory damages. 134 F.3d 371, 1988 WL 45487, at *1, *4.

**b. Lack of Enforceable Arbitration Agreements Expose Franchisors to Litigating Section 1981 Claims in Court**

When a dispute arises out of the failed negotiation of a franchise sale—for example, out of the refusal to grant a franchise—the franchise agreement’s arbitration clause does not apply because the parties never signed the franchise agreement. Absent a legally enforceable agreement, the franchisor cannot require the applicant to arbitrate. See Will-Drill Res., Inc. v. Samson Res. Co., 352 F.3d 211, 215 (5th Cir. 2003) (”Where no contract exists, there is no agreement on anything, including an agreement to arbitrate”).

To mitigate the risk of litigating Section 1981 or other pre-franchise agreement disputes in court, some franchisors may require prospects to agree to arbitration prior to entering into negotiations. But for these agreements to be effective, they must meet the essential requirements of a legally enforceable contract: offer, acceptance, and consideration. The *Alemayehu* case examined these issues and provided a road map for franchisors who wish to resolve pre-franchise agreement cases in arbitration.

In *Alemayehu*, the plaintiff, who owned no other franchises, submitted a written application to purchase a Subway franchise. *Doctor’s Assocs., Inc. v. Alemayehu*, 934 F.3d 245, 248 (2d Cir. 2019). After his application was denied, he sued the franchisor in the United States District Court for the District of Colorado, bringing a Section 1981 claim (among others) and alleging the franchisor denied his application on account of his race. *Id.* at 249. Although the prospect never signed the franchise agreement, his written application required binding arbitration of “any and all previously unasserted claims, disputes, or controversies arising out of or relating to [the prospect’s] application or candidacy for the grant of a SUBWAY franchise.” *Id.* at 248. The application further delegated to the arbitrators, and not the court, the authority to determine the validity and scope of the arbitration clause. *Id.* Subway therefore filed an action in the United States District Court for the District of Connecticut asking the court to compel arbitration. *Id.* at 249.

The District of Connecticut, applying Colorado law, concluded the arbitration clause in the franchise application was unenforceable for lack of consideration. *Doctor’s Assocs., Inc. v. Alemayehu*, 321 F. Supp. 3d 305, 310 (D. Conn. 2018). The court observed that in return for the applicant’s agreement to arbitrate, Subway had not (i) promised to consider the application, (ii) promised to give the applicant any additional information, or (iii) promised to respond. *Id.* Subway did not even sign the application. *Id.* at 312. According to the court, even assuming “that a promise to consider an application is sufficient consideration, that does not dictate the outcome in this case where no promise to review the Franchise Application was made.” *Id.* at 310. Subway then tried to argue that the promise to arbitrate was mutual, and that the mutual promises created consideration. *Id.* at 311. The district court rejected that argument upon concluding that the agreement was “‘not mutual: it is a unilateral promise to arbitrate by the applicant.’” *Id.*

Subway appealed the District of Connecticut’s decision to the United States Court of Appeals for the Second Circuit. Subway argued that the district court ruling “effectively invalidated thousands of arbitration agreements between [Subway] and anyone who completed
one of its applications to become a Subway® franchisee.” Brief of Plaintiff-Appellant, Doctor’s Associates, Inc., v. Alemayehu, No. 18-1865, 2018 WL 4862558, at *1–2 (2d Cir. Oct. 4, 2018). Subway also argued that the threshold arbitrability question should be decided by the arbitrator, and not the court. Id. at *22–31. Subway also disputed the trial court’s substantive decision on consideration, arguing that both its agreement to consider the applicant for an award of the franchise and its agreement to arbitrate provide sufficient consideration to arbitration. Id. at *33–45.

The Second Circuit reversed. It first held that a court, not the arbitrator, should decide the threshold question of arbitrability. 934 F.3d at 251–52. This was because the issue of consideration goes to the “fundamental question of whether [the parties] formed the agreement to arbitrate in the first place,” and to allow the arbitrator to resolve that question “would essentially force parties into arbitration when the parties dispute whether they ever consented to arbitrate anything in the first place.” Id. at 251. Next, the Second Circuit held that the arbitration clause in the franchise application was supported by sufficient consideration. It reasoned that consideration may take the form of a return promise or actual performance. Id. at 252. There was enough evidence in the record that in return for the promise to arbitrate, Subway gave the performance the prospect sought: it reviewed his application and considered him for the franchise. Id. The Second Circuit remanded the case so the district court could address other challenges to the arbitration clause. Id. at 254.

III. Best Steps Moving Forward.

a. Provide Consideration

Alemayehu provides franchisors with a potential path to send Section 1981 or other pre-litigation disputes to arbitration: the franchisor can require prospects to submit franchise applications with binding arbitration agreements. But Alemayehu also highlights the need for these applications to be supported by consideration. In Alemayehu, Subway established consideration by presenting evidence of performance; specifically, Subway actually reviewed the prospect’s application and considered him for a franchise. An alternative and less fact-intensive method of establishing consideration would be for the franchisor to make a return promise in exchange for the applicant’s agreement to arbitrate. For example, the franchisor could expressly make the arbitration obligation mutual. Or the franchisor could promise that in exchange for the agreement to arbitrate, it will consider the application, provide additional information, or merely respond to the application. The franchisor could implement a policy that in exchange for the agreement to arbitrate, it will deem applicants eligible to apply for the purchase of a franchise. Finally, because consideration is a matter of state law, franchisors and prospects should be well-versed in the consideration jurisprudence of the state whose law governs.

Franchisors may consider requiring prospects to submit a franchise application, containing a binding arbitration clause, as a condition to entering into negotiations for the sale of a franchise.

b. Comply with the FTC Franchise Rule and State Franchise Laws

Requiring prospects to submit a franchise application or agree to some other preliminary agreement is not without risk. For instance, adding an additional step into the process of selling a could take extra time, could deter prospects, and could slow the closing of the sale.

Moreover, the District of Connecticut did not address whether requiring the prospect
The Franchise Lawyer Fall 2019

17

to sign a binding arbitration agreement prior to providing an FDD runs afoul of the FTC’s Franchise Rule or state franchise laws. The FTC Franchise Rule requires franchisors to provide an FDD to the prospective franchisee “at least 14 calendar-days before the prospective franchisee signs a binding agreement with . . . the franchisor or an affiliate in connection with the proposed franchise sale.” 16 C.F.R. § 436.2. Several states require registration prior to offering to sell a franchise. See, e.g., Minn. Stat. §§ 80C.01(16)–80C.02 (requiring a franchisor to submit “an effective registration statement” prior to “every attempt to offer to dispose of, and every solicitation of an offer to buy, a franchise”).

These laws raise the question of whether a franchisor can require the prospect to sign a binding arbitration agreement prior to providing an FDD and filing registration documents in the required states. Although the statutes and regulations are ambiguous, one can make a good case that under the plain language of the FTC’s Franchise Rule, a franchisor must provide an FDD prior to requiring the prospect to sign an application. First, the application requiring arbitration must be a “binding agreement,” or else there is no point in asking the prospect to sign it. Second, the application likely is “in connection with the proposed franchise sale.” In this scenario, the application is a necessary step towards eventually consummating the franchise sale. For these reasons, the safest course of action is for the franchisor to provide the FDD and submit all required registrations prior to allowing the prospect to submit an application constituting a binding arbitration agreement.

Franchisors should recognize that absent a franchise application or other preliminary agreement with a binding arbitration agreement, they may be required to resolve Section 1981 or other pre-franchise agreement claims in court. In light of the Second Circuit’s opinion in Alemayehu, franchisors may elect to mitigate this risk by requiring that prospects sign franchise applications that require arbitration of all disputes arising out of or relating to the parties’ dealings with respect to potential franchise sales. Like all contracts, these preliminary agreements must be supported by consideration. And franchisors should take care that in implementing these preliminary agreements, they do not run afoul of the FTC Franchise Rule.

PAUL F. WOODY, ESQ., CFE
General Counsel, American Poolplayers Association, Inc.

Office location: Lake Saint Louis, MO

Practice specialties: Everything that comes with being a franchisor, litigation (a holdover from my pre-GC life), dispute resolution (a consequence of being a litigator)

Hobbies: Photography, public speaking, running, and, since taking my current job, playing pool

Best-loved song: Since “Take Me Out To The Ballgame” doesn’t sound like an answer a professional should give, Statesboro Blues by the Allman Brothers Band, or anything by Gary Clark, Jr. or Paul McCartney.

Favorite thing about the Forum: The practicality of the workshop topics and the willingness of the presenters to answer questions.

Something people would be surprised to learn about you: Something besides being the nation’s only pool lawyer? Well, I’ve summited 4 Colorado 14’ers and prior to practicing law, I was a staffer for Missouri’s 53rd Governor, and the Director of Communications for a caucus of the Missouri House of Representatives.
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Heather Carson Perkins has turned over the Editor-in-Chief reins to me. Thank you, Heather, for your outstanding job over the last three years, for making time for this role on top of your busy practice, and for spreading laughs and smiles along the way. Thank you also to our three veteran associate editors—Erin Conway Johnsen, Len MacPhee, and Keri McWilliams—and to our new associate editor, Ray Konz. The Forum is incredibly lucky to have your collective brainpower and editing prowess fueling this publication.

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