

# Not Your Mama's Advertising Fund: Best Practices in the Use of Franchise System Advertising Funds

*Lauren Smith Madden*

Advertising is the lifeblood of consumer-facing businesses. Even high-quality or innovative products, if not properly advertised, are unlikely to succeed in the consumer market. Conversely, a successful advertising campaign can create powerful, long-term recognition and goodwill for a brand. For example, individuals who grew up in the 1960s still remember the lyrics to “My Bologna Has a First Name,” while children of the 1980s and 1990s know exactly how many licks it takes to get to the center of a Tootsie Pop.



Ms. Madden

Franchising is not an exception to this principle. Indeed, the use of, and association with, a trademark, in conjunction with a specific and confidential business methodology, is what gives a franchise system its value.<sup>1</sup> That is why one of the three elements of a franchise in the Federal Trade Commission's (FTC) Disclosure Requirements and Prohibitions Concerning Franchising (Franchise Rule) is the right to operate a business that is associated with the franchisor's trademark.<sup>2</sup>

Due to the importance of advertising, virtually every franchise system requires advertising contributions by franchisees, and these contributions are then spent on advertising on behalf of the franchise system. These advertising contributions usually are held in some kind of fund or segregated account, often called an “advertising fund,” though the name of the account or entity varies based on the specific purpose of the contributions. Other common names include national and regional advertising funds, marketing funds, brand funds, and advertising cooperatives. Though they have not been as popular in recent years, advertising trusts are another structure that

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1. Abigail Rubinstein, *Seven Reasons Why Trademarks Are Important to Your Business*, ENTREPRENEUR (July 24, 2014), <https://www.entrepreneur.com/article/235887>.

2. 16 C.F.R. § 436.1(h).

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*Lauren Smith Madden (smithmadden@gmail.com) is a corporate attorney and was a Senior Associate at Frost Brown Todd in Louisville, Kentucky.*

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can be used for administering advertising funds.<sup>3</sup> Advertising funds, however administered, make a great deal of sense for most franchise systems. They enable franchisees to pool their funds and outsource their advertising needs to the franchisor or a third party. In this way, advertising funds save franchisees time that may otherwise be dedicated to advertising, time that they can instead invest in operations or other aspects of their franchised business. Pooled funds maximize value through economies of scale and consistency of message. Rather than hundreds of franchisees producing and placing their own advertisements (which may be inconsistent, confusing, or of varying quality), franchise systems can enjoy a cohesive advertising strategy funded by franchisee contributions. Advertising funds also create a feedback loop: more advertising boosts revenue, which boosts contributions, which boost advertising, which boosts revenue.

But for the same reasons that an advertising fund is useful and efficient, it can create tension in the franchise relationship. Franchisees may not know how their advertising fund contributions are being spent, or they may perceive that the funds are being wasted by the franchisor. They may dislike the advertisements produced or believe that they are not personally benefiting from their placement. Successful systems may not adjust their required advertising fund contributions as the system grows, leading to declining marginal benefits. Even otherwise healthy franchise systems may have problems balancing franchisee concerns with the functioning of an effective advertising fund.

Further complicating the picture, modern advertisers are exploring new media and unusual methods of advertising that precisely target their audiences, communicate with consumers directly, and capitalize on trending topics and current events. In August 2016, Kentucky Fried Chicken released a sunscreen that smelled like their famous fried chicken to coincide with the “Extra Crispy” chicken campaign.<sup>4</sup> SpaceX launched a Tesla Roadster and its mannequin passenger, Starman, into orbit in February 2018 to help publicize the test launch of its Falcon Heavy Rocket.<sup>5</sup> To publicize IHOP’s new line of burgers, IHOP teased its name being changed to IHOb, which the company revealed a week later stood for “International House of Burgers.”<sup>6</sup> These modern forms of advertising are exciting and interesting, but come with the potential to create challenges for franchise systems that established and developed advertising funds in previous decades. Now is an appropriate time for franchisors to take a fresh look at the advertising fund language in

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3. Erica L. Amarante & Eric H. Karp, *Best Practices in the Use of System Advertising and Marketing Funds*, ABA 34TH ANNUAL FORUM ON FRANCHISING W-5 (2011).

4. Michal Addady, *KFC is Making Sunscreen That Smells Like Fried Chicken*, FORTUNE (Aug. 22, 2016), <http://fortune.com/2016/08/22/kfc-extra-crispy-sunscreen>.

5. David Griner, *With a \$0 Ad Budget, Tesla Just Pulled Off One of the Greatest Marketing Stunts Ever*, ADWEEK (Feb. 7, 2018), <https://www.adweek.com/brand-marketing/with-a-0-ad-budget-tesla-just-pulled-off-one-of-the-greatest-marketing-stunts-ever>.

6. Ben Tobin, *IHOP Changes Name Back from IHOb*, USA TODAY (July 9, 2018), <https://www.usatoday.com/story/money/2018/07/09/ihop-changes-name-back-ihob/769310002>.

franchise agreements and other documents to ensure that it continues to accommodate modern trends. This article will therefore provide an overview of the legal issues that are likely to surround franchise advertising funds and then provide some tips on effective drafting of advertising fund language.

## I. Franchise Advertising Funds

### A. Addressing Advertising Funds in the Franchise Agreement

The franchise structure on its own does not provide some kind of inherent or innate authority of the franchisor to collect advertising funds from franchisees and to administer those funds. Instead, the franchisor must provide itself that right in the franchise agreement. It is up to the franchisor to decide how narrowly or broadly to draft those provisions. Some franchisors do not require an advertising contribution at the outset, but instead reserve the right to collect advertising fund contributions, using language such as “Franchisor reserves the right to establish, maintain, and administer an Advertising Fund.”<sup>7</sup>

Other franchise agreements contain clauses giving the franchisor broad rights to administer the funds, as well as any specific obligations. For example, the 2018 Great Clips Franchise Agreement grants the franchisor broad authority to make expenditures in its discretion, and disclaims any obligation for the expenditures to benefit franchisees directly or proportionately:

Great Clips has the sole and absolute right, within its own assessment of the general best interests of the Great Clips System, to determine the amount and nature of expenditure of funds collected into the Ad Fund for advertising, research, marketing, public relations, cause branding and various sales promotion programs and as to the selection of materials, programs, media and agencies on which said expenditures are made. Great Clips is not obligated to spend any amount collected into the Ad Fund in the [designated market area] in which the Salon is located.<sup>8</sup>

Some franchise agreements go into a great amount of detail about the franchisor’s powers, preferring to include as many uses of the advertising fund as possible and reserving sole discretion in administering the fund to the franchisor. The Potbelly Sandwich Shop Franchise Agreement includes a number of specific permitted uses for the advertising fund, including salaries, taxes, and overhead:

The Brand Fund may pay for creating, preparing, and producing video, audio, and written materials, graphics, and Electronic Media; developing, implementing, operating, and maintaining a Franchise System Website, . . . paying dues for membership and participation in franchising and industry associations . . . to pay for expenses we incur in activities reasonably related to directing the Brand Fund and its programs, including, without limitation, conducting market research, public relations, . . . collecting and accounting for Brand Fund contributions, and

7. *Microtel Franchise & Dev. Corp. v. Country Inn Hotel*, 923 F. Supp. 415, 419 (W.D.N.Y. 1996).

8. Great Clips Franchise Disclosure Document, p. 210 (issued Apr. 1, 2018).

taxes we must pay on Brand Fund contributions we receive; reasonable salaries and benefits of personnel who manage and administer the Brand Fund; a management fee for us (or an affiliate); the Brand Fund's other administrative costs; travel expenses of personnel while they are on Brand Fund business; meeting costs; overhead relating to Brand Fund business; and franchisee conferences.<sup>9</sup>

Franchise agreements may also include objective limitations, which may be helpful to balance the necessary discretion afforded to the franchisor in administering the funds with reasonable limitations needed to give comfort to franchisees. The Dunkin' Donuts Franchise Agreement states:

We may use up to twenty percent (20%) of Continuing Advertising Fees but none of the Additional Advertising Fees for the administrative expenses of the Fund for programs designed to increase sales and further develop the reputation and image of the brand.<sup>10</sup>

Finally, a significant number of franchise agreements disclaim any fiduciary duties owed from the franchisor to franchisees in the administration of the fund. An example of this kind of term is: "Although the Fund is not a trust, we will hold all Fund contributions for the benefit of the contributors and use contributions only for the purposes described in this Subsection. We do not owe any fiduciary obligation to you for administering the Fund or for any other reason."<sup>11</sup>

## II. Federal Law

No federal statute or regulation controls a franchisor's establishment or use of an advertising fund, but the FTC imposes a number of disclosure requirements in the Franchise Rule. The majority of the disclosures about the advertising fund are made in Item 11 of the franchise disclosure document.<sup>12</sup> The franchisor must describe any advertising funds in great detail:

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9. Potbelly Sandwich Shop Franchise Disclosure Document, p. 120–21 (issued Apr. 27, 2018).

10. Dunkin' Donuts Franchise Disclosure Document, p. 237 (issued Apr. 3, 2018).

11. Jimmy John's Franchise Disclosure Document, p. 152 (issued Apr. 25, 2018).

12. 16 C.F.R. § 436.5. Item 11 requires a franchisor to "[d]escribe the advertising program for the franchise system," including:

- (i) the franchisor's obligation to conduct advertising, including (A) the media the franchisor may use; (B) whether media coverage is local, regional, or national; (C) the source of advertising (for example, an in-house advertising department or a national or regional advertising agency); (D) whether the franchisor must spend any amount on advertising in the area or territory where the franchisee is located; (ii) the circumstances when the franchisor will permit franchisees to use their own advertising material; (iii) whether there is an advertising council composed of franchisees that advises the franchisor on advertising policies. If so, disclose: (A) how members of the council are selected; (B) whether the council serves in an advisory capacity only or has operational or decision-making power; (C) whether the franchisor has the power to form, change, or dissolve the advertising council; (iv) whether the franchisee must participate in a local or regional advertising cooperative. If so, state (A) how the area or membership of the cooperative is defined; (B) how much the franchisee must contribute to the fund and whether other franchisees must contribute a different amount or at a different rate; (C) whether the franchisor-owned outlets must

who contributes and how much,<sup>13</sup> whether franchisor-owned outlets contribute at the same rate,<sup>14</sup> who administers the fund,<sup>15</sup> whether the fund is audited,<sup>16</sup> whether financial statements of the fund are available to franchisees,<sup>17</sup> whether the franchisor uses advertising funds to solicit new franchisees,<sup>18</sup> what happens to any advertising funds that were not spent in the fiscal year in which they are collected,<sup>19</sup> and how the funds were used in the most recent year.<sup>20</sup> Although this list is hardly exhaustive of information about the advertising fund and its use, it arms potential franchisees with sufficient information to understand the basics of how the advertising fund works and may prompt further dialogue with the franchisor about the advertising fund.

Another federal law issue is the tax treatment of advertising funds. The Internal Revenue Service has attempted numerous times to have advertising funds be treated as income to the franchisor. Courts, however, generally hold that advertising fund contributions are not taxable, whether held in a separate account, trust, or other entity. In an early case, *The Seven-Up Company v. Commissioner of Internal Revenue*, the tax court held that advertising fund contributions made to 7-Up by its franchised bottling companies were not taxable because those contributions were not 7-Up's property; rather, 7-Up was "burdened with the obligation to use [the funds] for national advertising. No gain or profit was realized on their receipt because of this offsetting obligation."<sup>21</sup> More recently, the Fifth Circuit reversed a tax court ruling that

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contribute to the fund and, if so, whether those contributions are on the same basis as those for franchisees; (D) who is responsible for administering the cooperative (for example, franchisor, franchisee, or advertising agency); (E) whether cooperatives must operate from written governing documents and whether the documents are available for the franchisee to review; (F) whether cooperatives must prepare annual or periodic financial statements and whether the statements are available for review by the franchisee; (G) whether the franchisor has the power to require cooperatives to be formed, changed, dissolved, or merged; (v) whether the franchisee must participate in any other advertising fund. If so, state: (A) who contributes to the fund; (B) how much the franchisee must contribute to the fund and whether other franchisees must contribute a different amount or at a different rate; (C) whether the franchisor-owned outlets must contribute to the fund and, if so, whether it is on the same basis as franchisees; (D) who administers the fund; (E) whether the fund is audited and when it is audited; (F) whether financial statements of the fund are available for review by the franchisee; (G) how the funds were used in the most recently concluded fiscal year, including the percentages spent on production, media placement, administrative expenses, and a description of any other use; (vi) if not all advertising funds are spent in the fiscal year in which they accrue, how the franchisor uses the remaining amount, including whether franchisees receive a periodic accounting of how advertising fees are spent; (vii) the percentage of advertising funds, if any, that the franchisor uses principally to solicit new franchise sales.

13. *Id.* § 436.5(k)(4)(v)(B).

14. *Id.* § 436.5(k)(4)(v)(C).

15. *Id.* § 436.5(k)(4)(v)(D).

16. *Id.* § 436.5(k)(4)(v)(E).

17. *Id.* § 436.5(k)(4)(v)(F).

18. *Id.* § 436.5(k)(4)(vii).

19. *Id.* § 436.5(k)(4)(vi).

20. *Id.* § 436.5(k)(4)(v)(G).

21. *Seven-Up Co. v. Comm'r*, 14 T.C. 965, 979 (1950).

promotional account contributions to a wholesale food purchasing cooperative actually constituted disguised patronage dividends.<sup>22</sup> As the court held, “[The cooperative] had no right to receive the promotional account funds, supplied no service to Vendors based on the receipt of the funds, and was sufficiently constrained in the disposition of the funds. Under these circumstances, the Tax Court clearly erred by including the promotional account funds in [the cooperative’s] gross income.”<sup>23</sup>

### III. State Law

In addition to the disclosure obligations imposed by the Franchise Rule, state franchise statutes both directly regulate franchisor activities related to the collection and use of advertising funds and indirectly regulate advertising funds through good faith and other generally applicable requirements. Many states have statutes that generally prohibit deceptive or unfair acts by franchisors or affirmatively require the franchisor to act in good faith with franchisees.<sup>24</sup> A handful of states—Arkansas, Indiana, Iowa, Hawaii, and Washington—have statutes that specifically govern the use of advertising funds and restrict advertising service suppliers. Several other states prohibit discrimination in the treatment of franchisees; these requirements could potentially reach advertising funds.

#### A. Advertising Fund Specific State Statutes

Arkansas has a statute that prohibits franchisors from using funds collected for advertising on anything other than advertising.<sup>25</sup> Though the statute was enacted in 1977, no cases to date have interpreted it. It is unknown how a court would interpret the statute, but a franchisee could use the statute to challenge the use of advertising funds for activities or programming that do not strictly constitute advertising (for instance, charitable contributions, as discussed later), or if the advertising funds did not appropriately benefit the franchisee’s business.

Indiana law also prohibits franchisors from requiring or coercing franchisees to participate in advertising as an expense that is indeterminate, determined by a third party, or determined by a formula, unless the franchise agreement specifies the maximum sum or percentage of gross monthly

22. *Affiliated Foods, Inc. v. Comm’r*, 154 F.3d 527 (5th Cir. 1998).

23. *Id.* at 533.

24. *See, e.g.*, Fla. Stat. § 501.204 (“[U]nfair methods of competition, unconscionable acts or practices, and unfair or deceptive acts or practices in the conduct of any trade or commerce are hereby declared unlawful”); IOWA CODE § 523H.10 (“A franchise imposes on the parties a duty of good faith in performance and enforcement of the franchise agreement.”); N.C. GEN. STAT. § 75-1.1 (“[U]nfair and deceptive acts or practices in or affecting commerce, are declared unlawful.”); TEX. BUS. & COM. CODE ANN. § 17.46 (“[D]eceptive acts or practices in the conduct of any trade or commerce are hereby declared unlawful”); WASH. REV. CODE § 19.100.180 (requiring franchisors and franchisees to “deal with each other in good faith”).

25. ARK. CODE ANN. § 4-72-206(7).

sales that the franchisee may be required to pay.<sup>26</sup> In many cases, franchisors structure advertising fund contributions as a percentage of revenue or a regular flat fee, but, in more creative or irregular advertising fund contribution arrangements, the franchisor may run afoul of this statute.

### B. *Restrictions on Advertising Services Suppliers*

Some states have statutes that govern the franchisor's ability to restrict the source of goods and services in the franchise system. These statutes are generally targeted at required goods or services purchases, and the drafters were not likely contemplating their application to advertising. However, because the statutes are broadly written, an argument can be made that these statutes would reach advertising funds. Indiana statutes forbid franchisors from coercing or requiring franchisees to order goods or services that must be purchased exclusively from the franchisor or its designated sources where goods or services of comparable quality are available from other sources.<sup>27</sup> Iowa similarly requires franchisors to allow franchisees to obtain supplies and services from the sources of the franchisee's choosing, provided that they meet the franchisor's standards.<sup>28</sup> The Iowa statute includes an exception for goods or services that must be purchased from the franchisor, but only if those goods or services are central to the franchised business and are manufactured or produced by the franchisor, or incorporate a trade secret owned by the franchisor.<sup>29</sup> This exception may provide more flexibility for a franchisor to designate itself as the sole source of advertising services, based on the argument that the use of the trademark and advertising is central to the franchised business.

The Hawaii franchise statute prohibits a franchisor from requiring franchisees to purchase goods or services from the franchisor or a designated supplier unless reasonably necessary for a lawful purpose justified on business grounds.<sup>30</sup> The Washington statute is very similar and only permits franchisors to restrict the source of franchisee purchases if reasonably necessary for a lawful purpose justified on business grounds, and it does not substantially affect competition.<sup>31</sup> These statutes may limit a franchisor's ability to restrict advertising services to a single source (including the franchisor), or may require a franchisor to justify the restrictions. The applicability of these statutes will turn on whether the advertising fund is a "service" or the advertising itself is a "good."

26. IND. CODE § 23-2-2.7-1(11), 23-2-2.7-2(1)(iii).

27. *Id.* § 23-2-2.7-1(1), 23-2-2.7-2(1)(i).

28. IOWA CODE § 523H.12.

29. *Id.*

30. HAW. REV. STAT. § 482E-6(2)(B).

31. WASH. REV. CODE § 19.100.180(2)(b).

### C. Discrimination Among Franchisees

An even greater number of states have statutes that prohibit franchisors from discriminating among its franchisees. These statutes apply to a wide range of activities, including the collection and use of advertising funds. Advertising expenditures that disproportionately benefit some franchisees over others, for instance, may run afoul of a state anti-discrimination statute.

Illinois law states that it is an unfair practice for a franchisor to unreasonably and materially discriminate among franchisees in the charges for franchise fees or advertising services, unless the discrimination is based on a reasonable distinction.<sup>32</sup> Hawaii's statute is similar, but adds the requirement that the discrimination not be arbitrary.<sup>33</sup> Indiana prohibits franchisors from discriminating unfairly among its franchisees, which courts have interpreted narrowly, holding that "neither disparate treatment, nor even arbitrary disparate treatment, necessary suffices to make out a claim for unfair disparate treatment."<sup>34</sup>

Although Minnesota has not adopted a statute prohibiting discrimination between franchisees, the Minnesota Department of Commerce has issued a regulation prohibiting discrimination in the charges offered or made for goods, advertising services, or in any business dealing, unless the discrimination is based on reasonable grounds.<sup>35</sup> Washington similarly permits discrimination only if the franchisor can prove that it is (1) reasonable, (2) based on proper and justifiable distinctions (including franchises granted at materially different times), and (3) not arbitrary.<sup>36</sup>

## IV. Advertising Fund Litigation

Courts have been instrumental in clarifying franchisor obligations in administering advertising funds, and a robust body of case law has adjudicated the varied and creative claims that franchisees have brought against franchisors.

### A. Obligations to Establish Advertising Fund, or to Provide Advertising Support

Courts have historically not imposed an obligation to provide advertising support or services when it is not expressly provided for in the franchise agreement. For instance, in *In re Sizzler Restaurants International, Inc.*, franchisees brought suit against the franchisor for failure to provide advertising

32. 815 ILL. COMP. STAT. 705/18.

33. HAW. REV. STAT. § 482E-6(2)(C).

34. IND. CODE § 23-2-2.7-2(5). See *Gre-Ter Enters., Inc. v. Mgmt. Recruiters Int'l, Inc.*, 2018 WL 3145572, at \*10 (S.D. Ind. June 26, 2018) (dismissing the franchisee's claim that the franchisor failed to honor its territorial exclusivity constituted a violation of INDIANA CODE section 23-2-2.7-2(5) because it failed to demonstrate unfairness or unreasonableness, beyond simply constituting a breach of the franchise agreement).

35. MINN. R. 2860.4400.

36. WASH. REV. CODE § 19.100.180(2)(c).

support to the franchisees.<sup>37</sup> The operative franchise agreement language stated that the franchisor agreed “[t]o provide assistance and advice in the promotion of the general business welfare of [franchisee] as [franchisor] deems necessary from time to time for the maintenance of the SIZZLER method of operation.”<sup>38</sup> The court rejected the franchisees’ claims, explaining that the franchise agreements did not expressly obligate the franchisor to provide advertising support.<sup>39</sup>

Conversely, courts have also upheld the franchisor’s ability to establish advertising programs when subject to challenge by franchisees. The operative franchise agreement provision in *Honey Dew Associates, Inc. v. Creighton Muscato Enterprises, Inc.* required franchisees to participate and contribute to the franchisor’s programs, “which, from time to time, are supported by a majority of full producing Honey Dew Donut Shops.”<sup>40</sup> When the franchisor implemented an advertising program pursuant to this provision, the franchisees argued that they were not bound to participate because a formal vote of shops was a condition precedent to enforcement of the provision.<sup>41</sup> The court rejected this argument, finding that the plain meaning of the word “support” in the franchise agreement did not connote a formal vote requirement.<sup>42</sup>

However, once the advertising fund is established, franchisors are bound to use the funds for advertising according to the obligations in the franchise agreement. The court upheld a jury verdict against the franchisor for failure to spend collected advertising funds appropriately in *Rodgers v. Ohio Valley CFM, Inc.*<sup>43</sup> Despite the provision in the franchise agreement for the collection of funds to be allocated for advertising, the franchisor had not established a separate advertising fund account, and records showed that the franchisor spent nearly \$800,000 less on advertising for the franchise system than was collected over twelve years, not including several expenses that the franchisor retroactively allocated to the advertising fund.<sup>44</sup> The court resultantly found no error in the jury finding that the franchisor breached its contractual obligation to expend the collected funds on advertising.<sup>45</sup>

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37. 225 B.R. 466, 476 (Bankr. C.D. Cal. 1998).

38. *Id.* at 470.

39. *Id.* at 477; see also *Microtel Franchise & Dev. Corp. v. Country Inn Hotel*, 923 F. Supp. 415, 419 (W.D.N.Y. 1996) (rejecting the franchisee’s argument that the franchisor’s failure to establish an advertising fund constituted a breach of the franchise agreement, since the franchise agreement “reserve[d] the right to set up a national advertising fund,” and could thus not be the basis for a cause of action for breach of contract because Microtel’s obligation was discretionary).

40. *Honey Dew Assocs., Inc. v. Creighton Muscato Enters., Inc.*, 903 N.E.2d 239, 241 (Mass. App. Ct. 2009).

41. *Id.*

42. *Id.* at 242.

43. *Rodgers v. Ohio Valley CFM, Inc.*, 774 F.2d 1163 (table), 1985 WL 12787, at \*9 (6th Cir. Sept. 13, 1985).

44. *Id.* at \*3.

45. *Id.*

### B. Collection of Fees

In *Moghaddam v. Dunkin' Donuts, Inc.*, the court was asked to deliberate on the allocation of advertising funds recovered from underpaying franchisees.<sup>46</sup> The franchisor, when recovering underreported funds from franchisees, did not allocate any of the recovered amounts to the advertising fund.<sup>47</sup> The franchisees claimed this was a breach of the franchise agreement, though no provision specifically addressed how recovered funds should be allocated.<sup>48</sup> The court agreed with the franchisees, holding that the franchise agreement did not distinguish between advertising funds collected in the ordinary course of business and those collected as a result of loss-prevention activities.<sup>49</sup> The court also agreed with the franchisor that it did not have a duty to engage in the loss-prevention activities that generated the disputed funds, but found that, once the funds had been collected, the franchisor was obligated to correctly allocate them to the advertising fund.<sup>50</sup> A subsequent opinion on the same case clarified that the franchisor was only required to repay the recovered contributions to the advertising fund after a fair allocation of the costs of collection.<sup>51</sup>

### C. Enforceability of Statements in the Franchise Disclosure Document

Advertising fund litigation often focuses on the provisions in the franchise agreement relating to advertising and the advertising contributions. In situations where the franchise agreement does not fully address the issue, franchisees may be tempted to turn to the disclosures made in the Franchise Disclosure Document (FDD). To date, that strategy has not been particularly successful. The franchisee in *Gre-Ter Enterprises, Inc. v. Management Recruiters International, Inc.* complained that the franchisor's use of the advertising fund and failure to provide an accounting constituted a breach of contract, and relied on the disclosures in the FDD to support his claims.<sup>52</sup> The franchise agreement required payment of a national advertising fee, but did not specify how the funds were to be spent.<sup>53</sup> The FDD stated that the advertising fund would be used exclusively for advertising and "any other activities which [franchisor] believes will enhance the image of [its] offices."<sup>54</sup> The court held that the disclosure statements in the FDD were unenforceable because the franchise agreement's integration clause expressly stated that the franchise agreement represented the parties' complete and final

46. *Moghaddam v. Dunkin' Donuts, Inc.*, 295 F. Supp. 2d 136, 139 (D. Mass. 2003).

47. *Id.* at 138.

48. *Id.* at 139.

49. *Id.*

50. *Id.*

51. *Moghaddam v. Dunkin' Donuts, Inc.*, 322 F. Supp. 2d 44, 48 (D. Mass. 2004).

52. *Gre-Ter Enters., Inc. v. Mgmt. Recruiters Int'l, Inc.*, 2018 WL 3145572, at \*5-6 (S.D. Ind. June 26, 2018).

53. *Id.* at \*2 (noting that a subsequent version of the franchise agreement stated that the advertising funds were for franchisor's benefit, without further explanation or restriction).

54. *Id.* at \*3.

understanding regarding the subject matter and that there was no indication that the disclosure statements were intended to be enforceable.<sup>55</sup>

#### D. Direct Benefit from Advertising Fund

Advertising fund litigation frequently includes a claim by the franchisees that they received no benefit, or a disproportionately small benefit, from advertising fund expenditures in comparison to the franchisees' contributions. However, courts rarely adopt this argument, as franchise agreements generally give considerable discretion to the franchisor in the use of advertising funds.

In *Gregory v. Popeye's Famous Fried Chicken & Biscuits, Inc.*, the franchisee alleged that the franchisor had failed to satisfy its duty under the franchise agreement to provide adequate advertising or promotion.<sup>56</sup> The franchisee specifically alleged that the franchisor had failed to advertise in the Detroit area when the franchisee began opening stores there.<sup>57</sup> In part, the franchise agreement stated, "Franchisee understands that such advertising is intended to maximize the public's awareness of POPEYES Famous Fried Chicken restaurants, and that Franchisor accordingly undertakes no obligation to insure that any individual franchisee benefits directly or on a pro rata basis from the placement, if any, of such advertising in his local market."<sup>58</sup> Based on the clear language of the franchise agreement, the lower court dismissed the franchisee's claim, and the Sixth Circuit affirmed, holding that the parties' intent was that advertising fees were to be utilized for the ongoing promotion of the whole franchise system and that the franchisor was not obligated to allocate the franchisee's payments to Detroit area advertising.

The court in *JMF, Inc. v. Medicine Shoppe International, Inc.* reached a very similar conclusion.<sup>59</sup> There, the franchisees complained that the franchisor provided them with little local advertising, despite their required contributions to the business development fund, and that this failure was a breach of the franchise agreement.<sup>60</sup> The court granted the franchisor's motion for summary judgment and cited as support the language in the franchise agreements that the methods, media, and contents of advertising "shall be within the sole discretion of the [franchisor]" and that the franchisor "undertakes no obligation to insure that any individual franchisee benefits directly on a pro rata basis from the expenditures of the fund or from the placement, if any, of advertising or marketing."<sup>61</sup>

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55. *Id.* at \*5-7.

56. *Gregory v. Popeye's Famous Fried Chicken & Biscuits, Inc.*, No. 87-1461, slip. op. at 1 (6th Cir. Sept. 9, 1988).

57. *Id.* at 2.

58. *Id.*

59. *JMF, Inc. v. Med. Shoppe Int'l, Inc.*, 2011 WL 4369475, at \*6 (D.N.D. Sept. 19, 2011).

60. *Id.*

61. *Id.*

But the ability of a franchisor to use advertising funds as it sees fit is not boundless.<sup>62</sup> When a franchisee brought a claim against an International House of Pancakes subfranchisor for breach of the franchise agreement related to use of advertising funds, the court refused to dismiss the franchisee's claim.<sup>63</sup> The franchise agreement broadly granted the subfranchisor and franchisor sole discretion as to "all matters concerning the nature, location, placement or other aspects of the advertising to be conducted with [franchisee's] funds," but the court refused to extend absolute authority to the subfranchisor, stating that it "would permit [the subfranchisor] to initiate a cooperative marketing campaign, entice franchisees within the geographic region to vote in favor of the campaign, and then use the funds for the sole purpose of promoting [the subfranchisor's] own stores, while excluding the stores of the franchisees financing the marketing campaign."<sup>64</sup>

### E. Fiduciary Duties

In challenging a franchisor's use of advertising funds, franchisees have often argued that the collection and use of advertising funds created a fiduciary relationship, as the plaintiff franchisees did in *Collins v. International Dairy Queen*.<sup>65</sup> The franchisees in that case claimed that the franchisor had breached a fiduciary duty to manage the advertising fund in the best interest of the franchise system.<sup>66</sup> In support of the claim, the franchisees pointed to a letter from vice-president of marketing at the franchisor that stated that the franchisor has a "fiduciary responsibility" to each franchised store to expend the advertising funds and select the method and advertising agency that does the best job for the majority of franchised stores.<sup>67</sup> Despite this letter, the Court denied the claim of the franchisee, stating that "[c]ourts are in agreement that no fiduciary relationship results from a franchisor's management of an advertising fund" and that the vice-president's statement was insufficient to establish that a fiduciary relationship existed.<sup>68</sup>

Fiduciary duties, however, could exist in the right advertising fund scenario. In *Desert Buy Palm Springs, Inc. v. DirectBuy, Inc.*, the franchisees alleged that the franchisor had received payments from customers for orders

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62. See *Sunshine Rest. Partners, LP v. Shivshakti One, Inc.*, 2008 WL 4809096 (S.D. Fla. Nov. 5, 2008).

63. *Id.* at \*2.

64. *Id.*

65. *Collins v. Int'l Dairy Queen*, 54 F. Supp. 2d 1351, 1352 (M.D. Ga. 1999); see also *Broussard v. Meineke Discount Muffler Shops, Inc.*, 958 F. Supp. 1087 (W.D.N.C. 1997) (holding that fiduciary duties do not apply to the franchise advertising fund), *rev'd*, 155 F.3d 331 (4th Cir. 1998) (refusing to apply fiduciary obligations to the franchise relationship); *Offutt v. Doctor's Assocs. Inc.*, 2009 WL 10687786, at \*1 (D. Conn. Jan. 29, 2009) (holding that the franchisor had no standing to assert claim on behalf of the beneficiaries of the trust, the franchisees, but did sufficiently allege that the trustee also owes fiduciary duties to the franchisor, as the franchisor "can demonstrate a cognizable interest separate from the trust property and sufficient to assure 'concrete adverseness and diligence advocacy'").

66. *Collins*, 54 F. Supp. 2d at 1352.

67. *Id.* at 1353.

68. *Id.* at 1353-54.

and memberships, but then had refused to pay over the share of the payments to which the franchisee was entitled. The franchisee alleged that a trust relationship existed and therefore the franchisor had breached a fiduciary duty.<sup>69</sup> In considering this claim, the court first held that a fiduciary relationship “doesn’t exist unless a relationship of trust and confidence exists between the parties, and whether such a relationship exists is a question of fact.”<sup>70</sup> Based on this framework, the court denied the motion to dismiss of the franchisor because the allegations that the franchisee was a trustee in a position of confidence with the franchisee were sufficient to state a plausible claim for breach of fiduciary duty.<sup>71</sup> While this case did not relate to advertising payments, it is informative of how courts may handle claims in an advertising trust fund context.

### *F. Breach of Contract, Breach of Implied Covenant of Good Faith and Fair Dealing*

A significant proportion of litigation over use of advertising funds incorporates one or more claims of breach of the franchise agreement, or a breach of the implied covenant of good faith and fair dealing. Franchisees have had mixed results in asserting these kinds of claims.

The franchisees in *Hardee’s Food Systems, Inc. v. Hallbeck* objected to how the franchisor used advertising funds, claiming a breach of the covenant of good faith and fair dealing.<sup>72</sup> In particular, the franchisees pointed to “lewd” television commercials aired by the franchisor to claim that the franchisor had denigrated the franchise system’s brand image.<sup>73</sup> The court explained that the implied covenant of good faith and fair dealing requires a plaintiff to demonstrate that a defendant exercised its discretion to evade the spirit of the transaction or to deny the plaintiff the expected benefit of the contract. Applying this rule, the court refused to dismiss the claims of the franchisees, finding that the franchisees may be able to establish that the nature of the advertising denied the franchisees the expected benefit of the franchise agreement.<sup>74</sup>

Burger King Corporation came under fire for its use of advertising funds when franchisees claimed that Burger King had misappropriated and mismanaged funds paid by franchisees for advertising purposes, constituting a breach of the franchise agreement and of the covenant of good faith and

69. *Desert Buy Palm Springs, Inc. v. DirectBuy, Inc.*, 2012 WL 2130558, at \*5 (N.D. Ind. June 12, 2012).

70. *Id.* at 6.

71. *Id.*

72. *Hardee’s Food Sys., Inc. v. Hallbeck*, 776 F. Supp. 2d 949, 951 (E.D. Mo. 2011); see also *Clark v. Am.’s Favorite Chicken Co.*, 916 F. Supp. 586, 591 (E.D. La. 1996) (rejecting the Popeye’s franchisees’ claims that the franchisor’s marketing programs constituted a breach of good faith because a breach of good faith requires an analysis of whether one party has taken unfair advantage of another and unjustly enriched itself at the other’s expense, and the Popeye’s franchisees failed to show the franchisor’s intent or ill will to substantiate the claim).

73. *Hardee’s*, 776 F. Supp. 2d at 951.

74. *Id.* at 953.

fair dealing.<sup>75</sup> The franchisees specifically objected to Burger King's use of advertising funds to make a \$5 million donation to the American Red Cross, which Burger King argued was part of a legitimate promotion effort that generated substantial positive publicity.<sup>76</sup> The court rejected the franchisee's claims, stating that Burger King had met the express terms of the franchise agreement and that, absent any evidence that Burger King acted unreasonably or without proper motive, the courts are not entitled to second-guess the franchisor's economic decisions.<sup>77</sup>

Another court reached a more franchisee-friendly holding in *JM Vidal, Inc. v. Texdis USA, Inc.*, in which the franchisee sued the franchisor for a barrage of claims, including a breach of the franchise agreement and the covenant of good faith.<sup>78</sup> The franchise agreement at issue required the franchisee to make an initial contribution to the advertising fund of \$10,000, which would be matched by the franchisor and obligated the franchisor to maintain an advertising fund for "the design and production of national and regional advertising campaigns."<sup>79</sup> The franchisor was unable to substantiate whether it had matched the funds, and testimony from executives of the franchisor indicated that the franchisor did not have sufficient expertise to render suitable advertising support.<sup>80</sup> The court, reviewing these facts, denied the motion for summary judgment of the franchisor, stating that "a reasonable jury could conclude that [the franchisor's] efforts to promote [the franchisee's store's] opening were half-hearted at best, and that, more broadly, its advertising on behalf of the Store was knowingly insufficient to afford it a chance at success."<sup>81</sup>

Franchisees were also successful in their objection to the use of advertising funds in *Sherman v. Ben & Jerry's Franchising, Inc.*<sup>82</sup> The franchise agreement between the parties permitted the franchisor to "direct all marketing programs, with sole discretion over the concepts, materials, and media used in such programs and the placement and allocation thereof."<sup>83</sup> But the franchisees objected to advertising expenditures that "promoted a political agenda," such as the "Waffle Truth" campaign that was closely tied with Al Gore's "Inconvenient Truth" film, and directed consumers to Al Gore's website and online store, arguing that they did not constitute advertising.<sup>84</sup> Despite the broad language in the franchise agreement, the court refused to dismiss the

75. *Burger King Corp. v. Agad*, 941 F. Supp. 1217, 1221–22 (N.D. Ga. 1996).

76. *Id.*

77. *Id.*

78. *JM Vidal, Inc. v. Texdis USA, Inc.*, 764 F. Supp. 2d 599 (S.D.N.Y. 2011).

79. *Id.* at 607.

80. *Id.* at 607–08.

81. *Id.* at 615.

82. *Sherman v. Ben & Jerry's Franchising, Inc.*, 2009 WL 2462539, at \*1 (D. Vt. Aug. 10, 2009).

83. *Id.* at \*7.

84. *Id.* at \*1.

claim of the franchisees, as their allegations that the expenditures were not for advertising stated a plausible claim.<sup>85</sup>

In *Arcangelo, Inc. v. DirectBuy, Inc.*, the franchisees asserted a number of advertising fund-related claims against the franchisor, including breach of contract.<sup>86</sup> In relevant part, the franchise agreement set a cap on advertising fund contributions by franchisees at three percent of the gross amounts charged for new memberships.<sup>87</sup> However, overlapping definitions rendered the provision unclear.<sup>88</sup> The franchisor argued that the disputed charges were for sales leads that were not subject to a cap, while the franchisee argued that they were for national marketing and advertising programs subject to the cap.<sup>89</sup> Based on these arguments, the court denied the motion to dismiss of the franchisor, saying that the allegations are “sufficient to permit a reasonable inference that [the franchisor is] liable for breach of the Franchise Agreement.”<sup>90</sup>

## V. Modern Advertising Trends

### A. Social Media, Targeting Audiences

The advent of social media and the development of modern communication technology have had a profound impact on the methods and effectiveness of company advertising. These changes, in turn, can prove challenging to fit into existing franchise agreement language that often was drafted when these methods and technologies did not even exist. This section includes a summary of some modern advertising trends, which may require franchisors to revisit their franchise agreement language to ensure that it contemplates these newer methods of advertising.

Modern franchisors develop their branding and communicate with consumers directly through social media accounts. It is now commonplace for companies to generate content for Facebook, Twitter, Instagram, and other social media outlets as many as multiple times per day, including in response to current events and trending topics. Wendy’s, for instance, has developed a reputation for humorous and biting tweets in response to current events and mentions and tags by other users.<sup>91</sup> In response to IHOP’s recent name change to IHOb to highlight the system’s new line of burgers, Wendy’s tweeted, “Can’t wait to try a burger from the place that decided

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85. *Id.* at \*7.

86. *Arcangelo, Inc. v. DirectBuy, Inc.*, 2013 WL 6095678, at \*1 (N.D. Ind. Nov. 20, 2013).

87. *Id.*

88. *Id.* at \*2.

89. *Id.*

90. *Id.* at \*3.

91. Christina Huynh, *Fifteen Times the Wendy’s Twitter Was the Most Savage*, BUZZFEED (Feb. 22, 2017), [https://www.buzzfeed.com/christinajhuynh/15-times-wendys-twitter-was-more-shameless-than-y-2tfa4?utm\\_term=.mcYLpRGbp#.adlOmVgem](https://www.buzzfeed.com/christinajhuynh/15-times-wendys-twitter-was-more-shameless-than-y-2tfa4?utm_term=.mcYLpRGbp#.adlOmVgem).

pancakes were too hard.”<sup>92</sup> Similarly, Kentucky Fried Chicken (known for its famous recipe including eleven herbs and spices) humorously only follows eleven individuals on Twitter: six men named Herb and the five singers from the Spice Girls.<sup>93</sup> Social media presence helps the entire franchise system stay relevant in the context of current events and remain engaged with consumers.

Advertising also increasingly focuses on the brand and developing the brand’s identity over its products and services.<sup>94</sup> The franchisor, as owner of the trademark, is responsible for promoting the brand. And it is vital to develop a “unique, ownable, compelling and authentic brand story” that excites consumers.<sup>95</sup> Social media can be an invaluable tool to telling the story of the franchise brand, creating an outlet for franchisors like Wendy’s to generate humorous content that gives the brand a distinct personality.

Advertising has also become more sophisticated in recent decades and, instead of one-size-fits-all television commercials and billboards, is becoming increasingly targeted towards specific audiences.<sup>96</sup> Research around consumer habits can be an intensive and expensive process to undertake to better understand a target demographic of the franchisor, but such research can be helpful in assuring that the advertising is as effective and specific as possible.

While social media’s real-time feedback and interaction are immensely useful to improving the consumer experience and staying engaged with consumers, they are also demanding, require constant monitoring of trending topics and interactions, and can be very fickle. The Internet has become a repository for consumer feedback, and consumers expect that they may comment on their experience on social media and receive a prompt response from the company. Social media can be a double-edged sword, facilitating a firestorm of criticism or widespread praise.

In July 2018, two days after reports surfaced that John Schnatter, the founder of Papa John’s Pizza, had used an offensive racial slur, the University of Louisville announced that it would remove Papa John’s from the name of its football stadium.<sup>97</sup> The University’s decision was fueled by “[a] growing

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92. Lindsey Ramsey, *Wendy’s Is Trolling IHOP on Twitter after Changing Its Name to IHOB*, DELISH (June 11, 2018), <https://www.delish.com/food-news/a21270539/wendys-tweet-ihop-burgers>.

93. Lee Moran, *KFC Is Only Following 11 People on Twitter for a Totally Genius Reason*, HUFFPOST (Oct. 20, 2017), [https://www.huffingtonpost.com/entry/kfc-twitter-following-11-people\\_us\\_59e9d435e4b0f9d35bc9e7ee](https://www.huffingtonpost.com/entry/kfc-twitter-following-11-people_us_59e9d435e4b0f9d35bc9e7ee).

94. Jenni McKinnon, *How Agencies Are Killing It: Advertising Trends for 2018*, PAGELY (Feb. 1, 2018), <https://pagely.com/blog/advertisers-trends-2018>.

95. David Chapman, *Accelerate Your Brand with Content Marketing Strategies*, FRANCHISING WORLD, Feb. 2017, at 67, 68.

96. Ted Dhanik, *The Four Digital Trends that are Reshaping Advertising*, ENTREPRENEUR (Feb. 25, 2015), <https://www.entrepreneur.com/article/242393>; Brian Faust, *Five Top Advertising Trends in 2018: The Future Is Digital*, MARTECH ADVISOR (Jan. 8, 2018), <https://www.martechadvisor.com/articles/ads/5-top-advertising-trends-in-2018-the-future-is-digital>.

97. Morgan Watkins, *U of L Is Pulling Papa John’s off Cardinal Stadium after N-Word Scandal*, COURIER J. (July 13, 2018), <https://www.courier-journal.com/story/sports/college/louisville/2018/07/13/papa-johns-n-word-scandal-u-l-address-cardinal-stadium/783009002>.

chorus of criticism . . . including tweets from the accounts of U of L football players.<sup>98</sup> Conversely, in February 2018, Kentucky Fried Chicken (KFC) restaurants in the United Kingdom experienced a severe chicken shortage due to delivery problems.<sup>99</sup> KFC issued a cheeky apology and launched a twitter tool to direct consumers to their nearest open KFC, which garnered a positive social media response despite the supply chain fiasco.<sup>100</sup> For better or worse, social media empowers consumers to reach franchisors directly and gives consumers power in numbers.

### B. Non-Traditional Advertising

Non-traditional advertising is also becoming more commonplace, requiring companies to launch creative, subtle, and multifaceted campaigns. Recent years have seen the rise of “profit-with-purpose” organizations like Toms<sup>101</sup> that incorporate charitable giving and social responsibility into their business model.<sup>102</sup> There is increasing pressure on companies to act in a socially responsible way and to make charitable causes a focal point and financial priority.<sup>103</sup>

Social media has also spurred the inception of influencer marketing, which harnesses popular social media personalities to advertise their use of the product and the brand.<sup>104</sup> Companies must dedicate time to locating these personalities and enlisting them in the company’s advertising efforts. Similarly, native advertising is increasingly common, which is advertising that is not as explicit as traditional advertising and is instead generally hidden in a user experience like a blog post or online article.<sup>105</sup> The FTC has

98. *Id.*

99. *KFC Issued a Cheeky Apology for Running out of Chicken—But Now It Has a Gravy Problem*, SYDNEY MORNING HERALD (Mar. 1, 2018), <https://www.smh.com.au/business/companies/kfc-issued-a-cheeky-apology-for-running-out-of-chicken-but-now-it-has-a-gravy-problem-20180301-p4z27r.html> (noting that KFC’s parent company, Yum! Brands, is known for creatively engaging social media customers).

100. *Id.*; see also Flora Carr, *KFC Ran Out of Chicken. The Company’s New Ads Admit It FCKed up*, FORTUNE (Feb. 23, 2018), <http://fortune.com/2018/02/23/kfc-chicken-shortage-apology>.

101. Toms is a California-based company selling shoes, sunglasses, and other apparel, and is well known for its “One for One” program that donates one product to a person in need for each product purchased. *Company Information*, Toms, <https://www.toms.com/about-toms>.

102. David Taylor, *The Whiteboard: Can a For-Profit Brand Act Like a Nonprofit and Succeed?*, CENTRAL PENN. BUS. J. (Apr. 13, 2018), <http://www.cpbj.com/article/20180413/CPBJ01/180419953/the-whiteboard-can-a-forprofit-brand-act-like-a-nonprofit-and-succeed>.

103. Alison Coleman, *When Doing Good Is Great for Business*, RACONTEUR (May 9, 2017), <https://www.raconteur.net/future-franchising-2017> (“Whether it is supporting the local community, championing good causes or donating profits to charity, social responsibility is now part and parcel of the core business strategy of many franchises, at both corporate and local level.”).

104. Jenni McKinnon, *How Agencies Are Killing It: Advertising Trends for 2018*, PAGELY (Feb. 1, 2018), <https://pagely.com/blog/advertisers-trends-2018>.

105. Kate Wolwort, *Six Trends in Digital Advertising That Take Us to 2019*, DIGITAL DOUGHNUT (Feb. 27, 2018), <https://www.digitaldoughnut.com/articles/2018/february/trends-in-digital-advertising-that-take-us-to-2019>.

issued guidance on how this type of advertising is to be handled, especially when it involves celebrity endorsements.<sup>106</sup>

Modern advertising is more specifically targeted and responsive, but also more demanding, and research- and technology-intensive than in previous years. As franchisors seek to harness these modern trends and improve the efficacy of their advertising programs, there are some best practices they can keep in mind.

## VI. Best Practices in the Design and Use of Advertising Funds

### A. Drafting Agreements and Sticking to Them

First and foremost, the rights and obligations of the advertising fund must be set out in the franchise agreement and possibly in other ancillary agreements. Franchise relationships can be long, and it is impossible to predict every potential advertising and funding need or resource that may occur in the future. However, franchisors should consider setting out their authority as broadly as possible and explicitly authorize the use of advertising funds in non-traditional or new ways, even those not currently in existence. Next, franchisors can disclaim any fiduciary duties in the administration of the advertising fund. Similarly, franchisors should include specific authorizations for tangential expenses, such as costs of collecting advertising funds, litigation expenses related to the advertising fund, and reasonable overhead expenses.

As discussed above, it is becoming commonplace for organizations to incorporate charitable and social initiatives into their brand strategy. Cases like *Burger King Corp.* and *Sherman* show that political and charitable expenditures may be susceptible to challenges from franchisees even if the franchisor intended the expenditures for a genuine publicity purpose.<sup>107</sup> To the extent that a franchisor anticipates non-traditional advertising activities like political or charitable contributions, those should be addressed in the franchise agreement for the avoidance of doubt. As the saying goes, the best offense is a good defense, and franchisors can avoid a number of problems by drafting their own authority generously.

That being said, once the governing language is in place, a franchisor must ensure that the parties follow it in good faith. As noted previously, many franchisees challenge the use of advertising funds on the basis of breach of franchise agreement and breach of the implied covenant of good faith and fair dealing. The franchisor must be careful not to run afoul of either.

Further, franchisors should be careful not to discriminate arbitrarily or significantly in favor of some franchisees over others, or they may run afoul

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106. Press Release, FTC Staff Reminds Influencers and Brands to Clearly Disclose Relationship (Apr. 19, 2017), <https://www.ftc.gov/news-events/press-releases/2017/04/ftc-staff-reminds-influencers-brands-clearly-disclose>.

107. *Burger King Corp. v. Agad*, 941 F. Supp. 1217, 1218 (N.D. Ga. 1996); *Sherman v. Ben & Jerry's Franchising, Inc.*, 2009 WL 2462539, at \*1 (D. Vt. Aug. 10, 2009).

of state statutes. While it is impossible to benefit each franchisee in proportion to their contributions to the advertising fund, courts have generally given franchisors wide latitude with respect to the allocation of benefits to franchisees, as in *Gregory* and *JMF*.<sup>108</sup> Such case law, in connection with language that acknowledges that advertising is for the entire brand and may not benefit all franchisees equally, could serve as a defense if franchisees bring this type of claim.

### B. Accounting

In many cases, the franchise agreement requires the franchisor to prepare a regular accounting of the advertising fund. But even if it is not required, franchisors are well advised to prepare a regular accounting. This approach is especially true if the advertising fund is a separate account of the franchisor, rather than a separate legal entity. A skeptical franchisee may be concerned that the franchisor is commingling advertising funds with its own operating funds and unjustly enriching itself at the expense of franchisee advertising. Opening the books helps to generate trust in the franchise relationship. Further, because advertising funds held by a franchisor are not generally subject to federal taxes, they must be properly separated and accounted for to avoid co-mingling with taxable funds. If not properly accounted, this could subject the franchisor to significant additional taxes.

In *Rodgers*, the franchisor did not appear to be making the required advertising expenditures, and it began changing its accounting allocations after franchisees challenged them.<sup>109</sup> The court later found no error in the jury's finding that the franchisor breached its obligation to spend the funds on advertising, despite these retroactive accounting changes.<sup>110</sup> It is both instructive for the franchisor to know how it is expending the funds through a dedicated and thoughtful accounting process, and reassuring to franchisees to know where its advertising fund contributions are going. In this way, an accounting can help to address problems in the franchise relationship before they become significant.

### C. Transparency

Apart from an accounting, the franchisor should give consideration to how it communicates to franchisees the administration of the advertising fund. Secrecy and limited information can generate suspicion in the franchise relationship, even if no genuine cause for concern exists. If franchisors freely share information about the goals of their advertising and their future

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108. *Gregory v. Popeye's Famous Fried Chicken & Biscuits, Inc.*, No. 87-1461, slip. op. at 4 (6th Cir. Sept. 9, 1988); *JMF, Inc. v. Med. Shoppe Int'l, Inc.*, 2011 WL 4369475, at \*6 (D. N.D. Sept. 19, 2011).

109. *Rodgers v. Ohio Valley CFM, Inc.*, 774 F.2d 1163 (table), 1985 WL 12787, at \*9 (6th Cir. Sept. 13, 1985).

110. *Id.*

plans, franchisees are better able to buy into the strategy and feel comfortable with the franchisor's use of the funds.

The Great White North Franchisee Association—U.S., the association of Tim Horton franchisees, brought suit against its franchisor in 2017 for improper use of the advertising fund.<sup>111</sup> According to the franchisees, the franchisor has been using the advertising fund to pay for increasing administrative costs that were previously paid through operating revenues.<sup>112</sup> Further, the franchisees allege that the advertising fund was used to pay for customer service representatives, operations support workers, and regional office employees.<sup>113</sup> When speaking about the litigation, the franchisee association explained that it became necessary “due to [the franchisor’s] lack of transparency and unwillingness to answer important questions put to it in writing.”<sup>114</sup> At the time of publication, this litigation remains pending. Its outcome will certainly help inform views on proper advertising fund practices going forward. Honesty and transparency will generally only help to strengthen the franchise relationship and avoid litigation like Tim Horton’s is now facing.

#### D. *Advertising Councils, Advisory Boards, and Advertising Cooperatives*

As discussed previously, the trademark is one of the most significant value drivers in a franchise system. It is no wonder, then, that franchisors may be inclined to exert as much control as possible over advertising. Franchisors could consider involving franchisees in the advertising decision-making process, even if the involvement is limited in scope or authority. Franchisees may be appeased and comforted by the formation of an advertising council of franchisees that can review the advertising fund’s programming and provide feedback. Even if the franchisees are not granted any concrete authority to veto certain programming or generate their own content, having an open dialogue with the franchisor can improve communication between the parties and strengthen relations and trust. However, if an advertising council or similar advisory board is formed, care should be taken to clearly document and demarcate the authority and rights of the franchisor and the council members.

Franchisees can also be a helpful source of advertising information. As social media influencers and native advertising become more popular methods of advertising, advertisers have shifted from working with a few large advertising agencies to working with scores of influencer personalities or smaller media outlets. Franchisees are best acquainted with their local markets, and can be a source of significant help and inspiration as the franchisor

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111. Jonathan Maze, *Franchisee Sues Tim Hortons for \$500M over Ad Fund*, NATION’S RESTAURANT NEWS (June 22, 2017), <http://www.nrn.com/franchising/franchisee-sues-tim-hortons-500m-over-ad-fund>.

112. *Id.*

113. *Id.*

114. *Id.*

looks for effective non-traditional advertising opportunities, and can relate advertising material to local events and culture.<sup>115</sup>

e. *Harness New Technology to Involve Franchisees in Advertising*

Traditional forms of advertising like billboards and television advertisements are static in that they are placed by the franchisor and merely observed by the franchisees. One of the reasons that social media is so revolutionary and popular is because of the way that it can be used to reach large numbers of people, who can respond and interact directly back.<sup>116</sup> Further, franchisors can struggle to maintain a consistent brand identity while generating goodwill and specific advertising for individual locations.<sup>117</sup> In this way, social media presents a unique opportunity to involve franchisees in advertising.

## VII. Conclusion

The advertising industry is changing. Just as bell-bottom jeans fell out of fashion, so too have dated and static methods of advertising, replaced by more interactive and targeted media. In short, this is not your mama's advertising fund, and franchisors are innovating new and exciting ways to stand out and capture consumer attention.

Advertising funds are more than just a tool to finance advertising of a franchise system and should be viewed as way to deepen the relationship with franchisees and to harness their knowledge. And the advances in the advertising industry create an unprecedented opportunity to empower franchisees to magnify the effectiveness of system advertising.

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115. Chirag Kulkarni, *How Franchisees Can Build an Effective Social Media Marketing Strategy*, ENTREPRENEUR (Sept. 29, 2017), <https://www.entrepreneur.com/article/298216> ("Some of the benefits of having a local franchise include targeting your customers with local promotions and posting content that is directly related to local events. Social media lets you capitalize on those advantages.").

116. *Id.* (stating that social media is "an extremely effective outlet for not only telling a unique story but supporting customer acquisition and retention as well").

117. *How Can Franchisors Keep Their Brand Consistent on Social Media?*, GO DIGITAL, <https://www.godigitalmarketing.com/learn/blog/how-can-franchisors-keep-their-brand-consistent-on-social-media> (last accessed July 15, 2018).

