Not Just Between Us: Strategies for Disclosure of Settlement Agreements in the FDD

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When a long and bitter dispute between the franchisor and franchisee nears the finish line and the parties reach an agreement in principle, the attention of counsel turns to documenting the resolution, most often a settlement agreement. Attorneys take it almost for granted that the settlement agreement should have confidentiality provisions, usually thorough ones, often including at least a plausible inference to the kitchen sink. The mutual understanding is that this agreement is "just between us." There is, however, at least one other party to the settlement agreement—the Federal Trade Commission (FTC)—and it is willing to divulge the juiciest details to anyone who can get their hands on it.

Regulations governing franchising that the FTC promulgated in 2007 (FTC Rule) require franchisors to disclose in a Franchise Disclosure Document (FDD) the material terms of certain settlement agreements.[1] In negotiating and drafting the terms of the settlement, franchise counsel should test the proposed settlement against the FTC Rule's disclosure requirements to properly manage the impact of their required disclosure. Even before disputes arise, franchise counsel should give due weight to the disclosure requirements when crafting a dispute resolution procedure in the franchise agreement. Understanding the circumstances under which disclosure is required, and what specifically must be disclosed, will assist franchisors and counsel in making important decisions about settlement terms and their impact on subsequent disclosures.

Item 3 of the FTC Rule (Item 3) covers disclosure obligations relating to litigation, arbitration, and administrative actions broadly.[2] This article will

1. FTC Disclosure Requirements and Prohibitions Concerning Franchising, 16 C.F.R. § 436.5(c).
2. *Id.*

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focus only on the FTC's disclosure requirements as they relate to settlement agreements between franchisors and franchisees. The article first reviews which settlement agreements, and which terms within them, must or may be disclosed. It then discusses how the franchise agreement and FDD can be drafted to avoid or mitigate the impact of future disclosures. Finally, the article examines common settlement terms and circumstances, and how they might be addressed in litigation, negotiation, settlement agreements, and post-litigation FDD disclosures.

I. **Which Settlement Agreements and Terms Must Be Disclosed?**

The text of Item 3, including footnote text, is a mere 675 words. Determining the actual scope of Item 3's litigation disclosure requirements, however, is a more complicated endeavor, requiring review of the FTC's commentary accompanying publication of the final FTC Rule and its Franchise Rule Compliance Guide (Compliance Guide),[3] which expressly state limitations and refinements to the FTC Rule that are not found in Item 3's text. Reference should also be made to provisions of the old regulations governing franchise disclosure requirements and the guidance published by the North American Securities Administrators Association (NASAA).[4]

A. *Settlement Agreements That Must Be Disclosed*

Item 3 of the FTC Rule requires a settled case involving a franchisor or certain related parties[5] to be disclosed in the FDD if the case was

1. A material civil action in the last fiscal year involving the franchise relationship; or
2. A civil action alleging violation of a franchise, antitrust, or securities law, or fraud, unfair or deceptive trade practices, or comparable allegations (referred to herein as "Dishonesty Claims") in which the franchisor (or franchisor parties) was "held liable" within the ten-year period immediately preceding the issuance date of the FDD.

The first category (Franchise-Relationship Disclosures) contains three elements triggering the disclosure requirement: (1) a civil action; (2) that involves the franchise relationship; and (3) is material. Civil actions include

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3. Fed. Trade Comm'n, Franchise Rule Compliance Guide (2008); Disclosure Requirements and Prohibitions Concerning Franchising, 72 Fed. Reg. 15,444 (Mar. 30, 2007) (to be codified at 16 C.F.R. § 436).

4. NASAA published revised guidelines and a commentary to the revised guidelines. N. Am. Sec. Adm'rs Ass'n, Inc., 2008 Franchise Registration and Disclosure Guidelines (Amended and Restated UFOC Guidelines), http://www.nasaa.org/wp-content/uploads/2011/08/2008UFOC1.pdf); N. Am. Sec. Adm'rs Ass'n, Inc., Commentary on 2008 Franchise Registration, http://www.nasaa.org/wp-content/uploads/2011/08/FranchiseCommentary_final.pdf.

5. Parties covered by the litigation disclosures in Item 3 include all individuals listed in Item 2 (directors, trustees, general partners, principal officers, and any others with management responsibility relating to sales or operations of the franchise), predecessors of the franchisor, parents or affiliates promising or guaranteeing the franchisor's performance, and affiliates offering franchises under the franchisor's principal trademark. 16 C.F.R. 436.5(c)(1).

complaints, counterclaims, cross-claims, third-party complaints in litigation and their equivalent in arbitration (including outside of the United States), but specifically exclude mediation unless mediation results in settlement of a lawsuit that would otherwise have to be disclosed in Item 3.[6] "Franchise relationship" is directly defined by the FTC Rule as "contractual obligations between the franchisor and franchisee directly relating to the operation of the franchised business (such as royalty payment and training obligations)."[7]

"Materiality" is not specifically defined in the FTC Rule. The term was defined in the old FTC franchising rule (Old FTC Rule),[8] and the proposed FTC Rule submitted the following slightly-revised definition:

> *Material*, *material fact*, and *material change* includes any fact, circumstance, or set of conditions that has a substantial likelihood of influencing a reasonable franchisee or prospective franchisee in making a significant decision.[9]

However, following a recommendation made in the FTC Bureau of Consumer Protection's Staff Report (Staff Report),[10] the FTC removed the definition from the final FTC Rule, stating that it was not necessary because sufficient FTC jurisprudence regarding the definition existed and the new definition might cause a bifurcation of the jurisprudence.[11] Although not wanting specifically to include the definition in the FTC Rule, the Staff Report nevertheless defined "material" as "influencing the purchaser's decisionmaking [sic] process, such as the proposed Item 3 disclosure of 'material litigation.'"[12] Similarly, commentary in the FTC Rule considered as "material" any information likely to influence the reasonable prospective franchisee's decision to invest in the franchise.[13] Yet, the FTC then states in the Compliance Guide that all actions pertaining to the franchise relationship are "presumed to be material because they may shed light on problems in the franchise relationship or likelihood that the franchisor will resort to litigation against a franchisee."[14] The conservative approach would favor disclosing the settlement of any lawsuit or arbitration relating to the franchise

6. 16 C.F.R. § 436.1(a); Franchise Rule Compliance Guide, *supra* note 3, at 34–35.

7. 16 C.F.R. § 436.1(a). The definition excludes "actions involving suppliers or other third parties and indemnification for tort liability."

8. Franchising and Business Opportunity Ventures, 43 Fed. Reg. 59,614 (Dec. 21, 1978).

9. 64 Fed. Reg. at 57,332.

10. Fed. Trade Comm'n Bureau of Consumer Protection, Disclosure Requirements and Prohibitions Concerning Franchising: Staff Report to the Federal Trade Commission and Proposed Revised Trade Regulation Rule (16 C.F.R. pt. 436) (Aug. 2004) [hereinafter Staff Report]; Disclosure Requirements and Prohibitions Concerning Franchising, 72 Fed. Reg. 15,444 (Mar. 30, 2007) (to be codified at 16 C.F.R. § 436).

11. 72 Fed. Reg. at 15,455–56.

12. Staff Report, *supra* note 10, at 69.

13. 72 Fed. Reg. at 15,482, 15,455; Staff Report, *supra* note 10, at 69. The original FTC rule regulating franchising did define "materiality." Joseph Y. Adler & Michael R. Laidhold, *Assessing Materiality in Franchise Disclosure Documents: A Canada-U.S. Analysis*, 30 Franchise L.J. 245, 248 (2011) (discussing in great depth the different references to "materiality" in federal regulations and commentary, as well as state laws). The FTC rationalized its decision to omit a definition of "material" in the FTC Rule because it believed that "[m]ateriality is a cornerstone concept" of the past FTC jurisprudence relating to franchising. 72 Fed. Reg. 15,455.

14. Franchise Rule Compliance Guide, *supra* note 3, at 36.

relationship unless a strong case could be made that a prospective franchisee would find the substance of such litigation or arbitration uninteresting.[15]

Nonetheless, the FTC agreed in analyzing the FTC Rule that "favorable or neutral settlements to a franchisor [are] not material" and would not be disclosed and that "Item 3, therefore, permits franchisors to omit settled litigation where a settlement is favorable to the franchisor or otherwise neutral."[16] From this assessment, there may be at least some scenario in which a lawsuit that would otherwise have to be disclosed because it relates to the franchise relationship does not need to be disclosed because it is settled in the franchisor's favor. The commentary taken as a whole, however, seems to suggest that these statements were intended to target only the second category, and specifically whether a settlement agreement would be deemed to have "held liable" a franchisor.[17]

The second category (Prior Actions Disclosures) also contains three primary elements: (1) a civil action; (2) alleging certain Dishonesty Claims; (3) for which the franchisor was held liable. The first element is identical to the first category. The second is relatively self-explanatory.[18] "[H]eld liable," according to the FTC Rule, means that "as a result of claims or counterclaims, the [franchisor] must pay money or other consideration, must reduce an indebtedness by the amount of an award, cannot enforce its rights, or must take action adverse to its interests."[19] Thus, if an action under the second category is dismissed pursuant to a settlement agreement, but without payment of consideration by the franchisor, inability to enforce its rights, or obligation to take actions adverse to its interests, no disclosure is required.[20]

There is a distinction in the first category if the franchisor initiates the suit.[21] As long as the suit remains in the first category (i.e., it avoids Dishonesty Claims), the disclosure could arguably be limited to merely listing the lawsuit under a simple categorical heading, which would serve as the case summary, as provided by subsection 4 of Item 3. For example, if the franchisor sues the franchisee and a settlement agreement is reached in which the franchisor agrees to repurchase the franchised outlet from the franchisee,

15. The *Compliance Guide* provides a "notable exception": a lawsuit involving an isolated non-traditional unit *may* be of no interest to a prospective franchisee. *Id*.

16. 72 Fed. Reg. 15,479.

17. *See*, *e.g.*, 72 Fed. Reg. 15,479–83. For example, the franchisor-initiated claims section would not seem to make sense if such claims could be omitted if the matter was settled favorably to the franchisor.

18. The FTC Rule does not define "comparable actions," but would seem to include similar actions based on dishonesty and deceit, including embezzlement, conversion, and misappropriation of property. *See*, *e.g.*, Okla. Stat. tit. 71, § 808 (2017) (including in required disclosures all of the items contained in 16 C.F.R. § 436.5(c)(iii)(B) as well as several similar charges, and still including any other "comparable allegations").

19. 16 C.F.R § 436.5(c)(1)(iii)(B); *see also* Commentary on 2008 Franchise Registration, *supra* note 4, at 5 ("If a person is not required to pay a material amount or its rights are not materially restricted no disclosure is required.").

20. Franchise Rule Compliance Guide, *supra* note 3, at 38.

21. Note that the language specifically uses the word "suit" and not "action," which is used through the rest of Item 3. *See* 16 C.F.R. § 436.5(c)(4).

the disclosure might fall merely under the mundane category of "Suits to Collect Royalty Payments." There would be no requirement to disclose either the existence of the settlement agreement or its terms.

If the franchisee files a counterclaim, the subsection 4 summary exception disappears. This outcome is not found in the text of the rule, but instead in the commentary, which states that its intent is to require disclosure under subsection 3—and not 4—if any counterclaim is filed.[22] The commentary is difficult to mesh with other parts of the rule as well. Specifically, the use of the word "suit" in subsection 4, where all other references use the word "action," seems to encompass more than just an "action"—in other words; a "suit" is made up of more than one "action," one of which could be a counterclaim. Additionally, the exception is allowed for "any *other* franchisor-initiated suit identified in paragraph (c)(1)(ii)."[23] That means it must apply to only a part of those listed in subsection (c)(1)(ii). What "other" suits were intended to be covered is a mystery.

Consider the scenario in which a franchisee informs the franchisor that it will make no further royalty payments because the franchisor has not provided any support as required under the franchise agreement. The franchisor sues the franchisee for unpaid royalties. The franchisee files a counterclaim for the franchisor's lack of support—a purely contractual claim. This would still seem to fit into the realm of subsection 4 and not require disclosure because no Dishonesty Claims are asserted. However, based strictly on the commentary to the FTC Rule, full disclosure of any settlement agreement and its material terms must now be made for the next year.

Circumstances change when a claim is dismissed prior to settlement. The Compliance Guide expressly states that "dismissals, including a dismissal concluding an adversarial proceeding, need not be disclosed."[24] Importantly, this provision means not just total dismissals, but also individual dismissals of claims, become "nonmaterial" and disclosure of such claims is not required. This becomes more interesting in application of Prior Actions Disclosures. Consider a case in which a franchisee alleges breach of contract and fraud, the fraud claim is dismissed, and the franchisor then pays substantial money to settle the remaining contract claim. It is arguable that the franchisor was "held liable" because it settled a claim (the contract claim) by payment of money. Thus, it would seem that because the action at the outset "involved" a fraud claim, the franchisor has "been held liable in a civil action involving an alleged violation of . . . fraud," and must disclose the settlement and its material terms for ten years. However, the Compliance Guide makes clear that the dismissed claim does not trigger disclosure.[25] In other words, at the time the settlement agreement was entered (i.e., the franchisor was "held liable"), the civil action no longer involved Dishonesty Claims. Therefore,

22. 72 Fed. Reg. 15,483.
23. *Id.* (emphasis added).
24. Franchise Rule Compliance Guide, *supra* note 3, at 38.
25. *Id.*

disclosure must only be made for one year pursuant to the Franchise Relationships Disclosure in subcategory (c)(1)(ii).

B. *Terms of the Settlement Agreement That Must Be Disclosed*

If the settled case must be disclosed because it fits into either of the two categories above, the FTC Rule explicitly requires that all *material* terms of the settlement agreement must be disclosed, "whether or not the agreement is confidential."[26] This raises anew the question of materiality. Is there a different definition for "material litigation" versus "material term" of a settlement agreement relating to the litigation? Should "material" be read in the context of what terms of the settlement agreement a prospective franchisee would consider material to its decision to invest in the franchise, or should it be read closer to its general definition—"significant" or "important"—as it appears that term is used in Item 8? This distinction was at least one of the reasons the Staff Report recommended that the definition of "material" be dropped from the FTC Rule.[27] The question is not an easy one.

On the one hand, "material term" is used in the FTC Rule in the specific context of a settlement agreement—a contract.[28] Thus, it is helpful to look to how the term is used in contract law. *Black's Law Dictionary* defines "material term" as "[a] contractual provision dealing with a significant issue such as subject matter, price, payment, quantity, quality, duration, or the work to be done."[29] It is any term without which the parties would not have entered into the contract; "one that goes to the essence of the agreement."[30] Certainly, "[o]ne of the most material terms of a contract or grant is the consideration."[31] Which other terms of a particular contract are actually material is a question of law that must be addressed case by case.[32]

On the other hand, the overarching purpose of the FTC Rule's litigation disclosure is to provide information to prospective franchisees that is likely to influence their decision to invest in the franchise.[33] The specific reason for requiring disclosure of material settlement terms is because "settlement of an action does not diminish its materiality if the franchisor agrees to pay material consideration or agrees to be bound by obligations which are materially adverse to its interests."[34] Thus, it can be fairly argued that "material term"

26. 16 C.F.R. § 436.5(c)(3)(ii) n.2 (emphasis added). The FTC Rule also requires additional information about the underlying action to be disclosed in the FDD, including at least the title, case number or citation, initial filing date, names of the parties, forum, the relationship of the opposing party to the franchisor, and (unless excepted by subsection 4) a summary of the legal and factual nature of each claim in the action, the relief obtained, and any conclusions of law or fact. *Id.*

27. Staff Report, *supra* note 10, at 68–69.

28. 16 C.F.R. § 436.5(c)(3)(ii), note 2.

29. *Material Term*, Black's Law Dictionary (10th ed. 2014).

30. Mich. Model Civil Jury Instr. § 142.13; N.M. Uniform Jury Instr. (Civil) § 13-802.

31. Providence Bank v. Billings, 29 U.S. 514, 554 (1830).

32. Fischer v. CTMI, LLC, 479 S.W.3d 231, 237 (Tex. 2016).

33. 72 Fed. Reg. 15,482.

34. *Id.* at 15,479.

in the contractual sense is too broad of a standard. Otherwise, a franchisor is left in the position to argue that, as between itself and the settling franchisee, each and every term in the settlement agreement is material (that it would not have entered into the settlement agreement if, for example, it thought that the franchisee could ignore a non-disparagement provision), but, with respect to what it should have to disclose in the FDD, the franchisee will not find material much beyond what money was paid and what concessions to the franchise relationship were made or what was given in exchange for the money.[35] Of course, a franchisee or prospective franchisee will maintain that *all* of the settlement terms are material because they provide valuable insight into the franchisor and its dispute resolution tendencies.

Perhaps a third approach—a hybrid of the two—is more appropriate: material settlement terms are those terms in the settlement agreement that cause the relationship between the franchisor and franchisee in litigation to vary from the relationship represented in the FDD. These variations, above all else, would be the influencing factors for a franchisee's decision to invest. For instance, payment of money by franchisor to franchisee in settlement varies from the advertised value proposition in the FDD, which has the franchisee paying money to the franchisor for certain rights, products, and services. Other changes to the franchise agreement, like royalty reduction or restructuring, reduction of the scope of noncompetition agreements, or loosening of required purchases or standards, all suggest that the franchisor has acquiesced to altering the franchise relationship at least between itself and one franchisee. Similarly, Dishonesty Claims, whether settled by payment of money, rescission, or other alteration of the terms of the relationship between franchisor and franchisee would be disclosed. However, this standard would not require disclosure of every contractually material term, like non-disparagement, release, reaffirmation of franchise agreement obligations, return of franchise materials, and de-identification requirements. Admittedly, it is not a perfect rule, but one that appears, by review of a brief sampling of settlement disclosures, to be general practice across franchise systems.[36]

C. *Confidentiality Provisions Must Be Disclosed*

Item 20 of the FTC Rule requires a franchisor to disclose whether any of its franchisees signed confidentiality clauses in the last three fiscal years.[37] The FTC Rule defines "confidentiality clause" specifically to include a

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35. This is exhibited by an Item 3 disclosure of a top-fifty (Entrepreneur 2018 Franchise 500 Ranking) franchisor stating the following in two separate settlement disclosures: "The principal terms of the settlement are confidential but involved payment of $17,500 to the former franchisee by [franchisor]"; "[t]he principal terms of the settlement are confidential but involve [franchisor] purchasing the former franchisee's two [locations] for $400,000."

36. In researching for this article, the author reviewed a sample of approximately twenty FDDs containing Item 3 disclosures of settlement agreements of franchisors ranking in the top fifty of the Entrepreneur 2018 Franchise 500 Ranking ("Item 3 Top-50 Review").

37. 16 C.F.R. § 436.5(t)(7).

"settlement provision that directly or indirectly restricts a current or former franchisee from discussing his or her personal experience as a franchisee in the franchisor's system with any prospective franchisee."[38] The section then dictates specific language by which the franchisor must disclose this information in the FDD.[39] The requirement to disclose also permits a franchisor to disclose the number or percentage of franchisees that have signed confidentiality clauses and the circumstances under which they were signed.

D. *Item 20 Disclosures*

Settlement agreements may also impact the reporting of the franchise system's outlets required by Item 20 of the FTC Rule.[40] This obligation is obvious with respect to outright terminations, but is less so when negotiating exits or alternative relationships with larger franchisees or groups of franchisees. After initiating litigation or even before doing so,[41] franchisor and franchisee parties may decide it would be better for both parties to move away from a franchising model altogether and consider a "franchise lite" or licensing arrangement. Such negotiations are complex, and the franchisor's disclosure obligations are often not at the forefront.

They should be. A franchisor, particularly in a new and rapidly growing system (in which momentum more than track record drives growth), should consider the effect of moving a large number of units from a franchise model to a license model. Although the decision may be completely unrelated to growth—and may actually help future growth—in the franchise system, reporting that numerous outlets were terminated will need to be explained. Counsel for the franchisor should consider whether the arrangement could be safely kept within the franchise context to avoid a significant change in Item 20. The franchisor should also consider whether allowing it to clarify that these franchisees receive different treatment because they operate under a different arrangement outweighs the effect of reporting multiple concurrent terminations.

38. *Id.* § 436.1(c). The provision does not actually require disclosure of *all* confidentiality clauses signed by franchisees—only those that prohibit discussion with prospective franchisee. *See also* 72 Fed. Reg. 15,455 ("This being the disclosure's purpose, the operant definition is limited to confidentiality clauses impinging on communications between current or former franchisees and prospective franchisees only. It would not cover clauses that prohibit communications between current or former franchisees and, for example, the media."); Franchise Desk Book 1155 (W. Michael Garner ed., 2d ed. 2012) (discussing additional categories excluded by the definition of "confidentiality clause"). As a practical matter, this distinction is not significant for purposes of settlement agreements between franchisor and franchisee because the agreements will (or at least should) contain confidentiality provisions restricting what franchisees may divulge to everyone (including prospective franchisees).

39. 16 C.F.R. § 436.5(t)(7).

40. *Id.* § 436.5(t).

41. Item 20 disclosures are not dependent on litigation. *Id.* § 436.5(t). Therefore, any change in unit counts requires disclosure.

II. Drafting the Franchise Agreement to Limit Dispute Disclosures

A franchisor cannot change the FTC Rule, but it can limit and control the circumstances under which the FTC Rule's disclosure requirements are triggered by incorporating sound dispute resolution procedures in the franchise agreement and ensuring that adequate care is taken in drafting disclosures of pending litigation.

A. *Dispute Resolution Techniques to Avoid Settlement Agreement Disclosure*

The best defense to litigation disclosure is not, as the old adage says, a good offense. That would be the second-best defense. The best defense is a well-crafted franchise agreement and, specifically, its pre-action dispute resolution procedures. The premise is simple: so long as no "action" (i.e., litigation or arbitration) is initiated, no disclosure requirement exists. Many, if not most, franchise agreements already contain some form or other of pre-suit notice to the franchisor.[42] These range from simple notices to elaborate informal meetings with the franchisor and extended pre-"action" mediation.

1. Notice of Claims and Informal Meeting

The most basic pre-suit procedural requirement is a notice requirement. For example: "At least ten business days prior to bringing any claim or dispute between you and us, you must first bring it to our attention by providing us written notice and demand." Onto this requirement the franchisor can add another that the franchisee specify in detail the claims or disputes as well as a requested resolution. Both requirements are often used as precursors to a required informal meeting with the franchisor's management to attempt to reach a resolution.

Requiring a meeting with the franchisor's management can be a useful tool, particularly for franchisors with long or circuitous chains of command. This course gives leadership at the franchisor an opportunity, perhaps for the first time, to hear a franchisee's grievances direct and unfiltered.

2. Mediation

Mediation is often the prerequisite in franchise agreements to litigation or arbitration. Proponents tout its speed and cost-effectiveness, as well as a host of other advantages over litigation and arbitration.[43] Not often included in the list of perceived advantages is the ability to avoid disclosure of the

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42. In the Item 3 Top-50 Review, just over half of the franchise agreements required mediation or some other advance notice prior to commencing an action.

43. For example, mediation allows an opportunity for the parties to preserve a business relationship, can allow the parties to express viewpoints and frustrations, and gives the parties an opportunity to preview the other party's positions and assess strengths and weaknesses. Franchise Litigation Handbook 314–15 (Dennis LaFiura & Griffith Towle eds., 2010). It can also allow for more creative resolutions as compared to the win-lose scenario faced in litigation or arbitration. Peter Klarfeld, Michael Lewis & Peter Silverman, *Mediation: Negotiating Franchise Disputes*, ABA 32nd Ann. Forum on Franchising at W-12, 2 (2009).

dispute in the FDD if resolution can be reached prior to litigation or arbitration. With knowledge that a settlement obtained in mediation will be kept confidential, a franchisor is freed from considering the impact of those reported settlement terms to prospective franchisees and, more importantly, the fuel that it may provide to other disgruntled franchisees.[44] Franchisees, too, should understand the added value this may bring to them in a pre-litigation settlement and should perhaps not be too quick to file suit. This possibility, of course, depends on a certain level of reasonableness and willingness to accept the potential negative consequences of mediation.

Mediation does have potential disadvantages. For instance, it requires parties that are able *and* willing to compromise.[45] Parties may also fear disclosing their positions, strategies, and weaknesses in the event that the matter is not resolved by mediation. In these instances, mediation can simply be a waste of time and money.

Before deciding to exclude a mediation prerequisite from its franchise agreement, a franchisor should consider the viability of a mediation prerequisite applicable only to the franchisee that the franchisor can elect to waive, particularly when the mediation requirement is coupled with a requirement that the franchisee state the claims it intends to pursue. This option preserves the right for the franchisor to demand mediation, allowing the franchisor to decide to mediate or not aided by information about the dispute that is the subject of mediation.[46]

Franchisors should not use litigation or arbitration prerequisites as a means to delay or drive up the cost of litigation. Although certainly tempting, and possibly effective in certain circumstances, if they are structured or used primarily for purposes unrelated to a sincere attempt to resolve claims fairly, such prerequisites will serve only to embitter and entrench. Moreover, perception is important. If fair and defined litigation prerequisites are set forth in the franchise agreement and used judiciously, the franchisor is most likely to reduce the size of its Item 3 disclosures.

III. Negotiating and Drafting Settlement Agreements and Pending Litigation Disclosures in Light of Disclosure Requirements

Although the primary objective of a settlement agreement is to memorialize the parties' agreement to resolve a dispute between them, what the franchisor will have to disclose should play a role in the terms and verbiage

44. *See*, *e.g.*, Klarfeld, *supra* note 43, at 13 (discussing reluctance of franchisors to appear that they settle easily or seriously erred).

45. Many disputes are not particularly amenable to mediation. For example, claims for injunctive relief or to enforce system standards may have little room for flexibility to compromise. Franchise Litigation Handbook, *supra* note 43, at 314.

46. Not all provisions requiring pre-litigation mediation will be enforced. *See generally* Elizabeth M. Weldon & Patrick W. Kelly, *Prelitigation Dispute Resolution Clauses: Getting the Benefit of Your Bargain*, 31 Franchise L.J. 28 (2011) (discussing, among other things, enforceability of mediation prerequisites).

to which it is willing to commit. Assuming that litigation or arbitration has commenced and that the franchisor desires to settle and recognizes that settling will result in the franchisor being "held liable" under the FTC Rule, the franchisor must be prepared to disclose all material settlement terms.

A. *Terms to Disclose and Strategies for Minimize Disclosure and Its Impact*

As discussed above, there is not particular clarity in the FTC Rule or related guidance about what "material settlement terms" encompass. Based on the definition for material settlement terms proposed in Section I above, terms in a settlement agreement that cause the relationship between the franchisor and franchisee in litigation to vary from the relationship represented in the FDD should be disclosed. Consider the following terms common to settlements of franchise disputes:

1. Payment, Foregoing or Deferring Payment, and Debt Forgiveness

There is no question that the amount a franchisor pays in a settlement is a material term of the settlement agreement and must be disclosed.[47] This is true for any form of payment, whether categorized as debt forgiveness, foregoing or deferring collection of payment, or providing goods or services without a charge.[48] It remains true even if the franchisor receives fair value in return for the payment, as in the case in which the franchisor purchases the franchisee's business for a price at or below its market value.[49] This is not the case, though, if a third party purchases the franchise and the franchisor's approval is required for the purchase.[50] In such instance, the franchisor could insist on dismissal of the litigation and execution of the release prior

47. In most of the disclosures in the Item 3 Top-50 Review, the amount of payment by the franchisor, if any, was reported. Exceptions included disclosures in one FDD that neglected to specify the amount when the franchisor's insurer paid the amount and when its international affiliate settled (though in the latter it was not clear whether money was paid); a disclosure stating that the franchisor "agreed to purchase 5 of [franchisee's] 6 franchised restaurants for an amount [franchisor] determined to represent their fair market value"; and a disclosure relating to a franchisee's employee suing the franchisor, which was settled, but no terms regarding the settlement agreement were disclosed.

48. *See* 16 C.F.R. § 436.5(c)(1)(iii)(B) (defining "held liable" to include payment of money "or other consideration").

49. A strong case could be made that a franchisor's repurchase of a franchise outlet for market value or less than market value would be a favorable settlement that could exempt the underlying litigation from disclosure. For instance, in a termination scenario in which the franchisee brings meritless claims, the franchisor may agree to pay a small sum for the outlet purely to allow for an uninterrupted transition of the location; the franchisor might also make significant money selling the location shortly thereafter. The case is weakened, though, by the fact that the sale had to be made to resolve the claims (i.e., the franchisee did not release the claims voluntarily without the quid pro quo). Purchase price well below market price may also indicate bigger problems in the franchise system, like resale values significantly below initial investment costs. Consistent with the FTC's guidance, there should be a presumption in favor of disclosure. Franchise Rule Compliance Guide, *supra* note 3, at 36.

50. If the third party is affiliated with the franchisor, disclosure would be prudent. Multiple franchisors in the Item 3 Top-50 Review disclosed settlement of a case where an affiliate purchased the franchise to resolve a lawsuit.

to approving the transfer.[51] The franchisor would not be entering into a settlement agreement. Rather, the claims would be dismissed pursuant to the terms of the franchise agreement making a transfer approval contingent on the franchisee's releasing of the pending claims against the franchisor. As discussed earlier, the dismissed action would not be subject to disclosure.[52]

When the franchisor agrees in settlement to buy the franchise, even if disclosure is required, a prospective franchisee can at least be expected to consider that the franchisor may have received some value in exchange for its payment. On the other hand, if very little is paid for the franchise, it may discourage potential franchisees from opening new locations if they perceive that the franchisor's purchase is a market rate purchase and a new location would cost substantially more.

Another strategy in disclosing a franchisor's payments is to categorize what payments are for in the settlement agreement. When the settlement terms are disclosed, the franchisor can control the perception of prospective franchisees by reducing the "sticker shock" of a settlement payment by breaking it up between categories, some of which the franchisee may deem insignificant. For instance, part of the payment could be in exchange for the assets of the franchisee or for attorney's fees and costs. This latter technique also serves to caution franchisees considering litigation against the franchisor that they will incur significant costs in doing so.

A slightly more dubious tactic was present in the Item 3 Top-50 Review: the disclosure stated a large aggregate amount (more than $2 million) alleged by multiple franchisees against the franchisor. It then disclosed that the claims were resolved by payment of $25,000 to each franchisee. Nowhere in the disclosure was the number of franchisees involved in the litigation disclosed, leaving the reader unable to determine the actual amount for which the franchisor was "held liable." The omission leaves ample room for a claim against the franchisor by a franchisee who enters the system and later finds that the litigation involved a significant number of franchisees and a large settlement.

2. Amendments to Franchise Agreements or Operations Manuals

When the parties to litigation intend to continue operating as franchisor and franchisee, the franchisor often commits to some change in operations, even if not actually a direct amendment to the franchise agreement. If a settlement agreement provides for amendment of the franchise agreement, operations manual, or other agreement between the franchisor and franchisee, it would be difficult to argue that such a term is not material to the

51. This may not be a viable or complete option. In Michigan and Washington, for example, a release may be required, but cannot cover claims arising under the respective franchise relationship statutes. *See* Franchise Mgmt. Unlimited v. America's Favorite Chicken, 561 N.W.2d 123, 242 (Mich. Ct. App. 1997); Phyllis Alden Truby & David A. Beyer, *Fundamentals 201: Transfers & Assignments in Franchising*, ABA 37th Ann. Forum on Franchising, at 11–12, 14 (2014).

52. *See supra* Section I and note 23.

agreement under either the contractual or disclosure perspective discussed earlier. Consequently, if resolution of the dispute requires amendment, a franchisor should consider how the impact of such an amendment can be minimized across the system. Clearly, the franchisor wishes to avoid disclosing a special deal made with one franchisee or group of franchisees to avoid discord in the system. Therefore, before agreeing to amend the franchise agreement, a franchisor should consider whether the amendment could be offered system-wide. Although certainly not possible in all circumstances, the franchisor may, by thinking creatively, craft a solution that permits all other franchisees to participate equally in the amendment. For instance, if the franchisees involved in the litigation all have at least five franchise units, the agreement could provide a royalty reduction for owners with more than five stores and a minimum threshold of sales revenue. Of course, the franchisor should closely consider the impact system-wide (present and future) before making the offer. If the franchisor can find a solution that can be applied eventually to all franchisees, the disclosure impact will be greatly minimized.

3. Waiver of Post-termination Provisions

A franchisee that has left or intends to leave the franchise system and desires to keep operating will demand some relief from post-termination covenants and obligations—particularly a noncompetition agreement—if the franchisee has any leverage. This scenario is one of the most dreaded for franchisors, who envision that such a request opens the floodgates. By voluntarily eliminating or reducing post-termination noncompetition agreements, the franchisor can be viewed as believing its protections are not enforceable. To mitigate, franchisors should consider boxing this in as much as possible, beginning with elements about which the franchisee does not care. For example, a franchisee may have no ambitions to expand beyond its current operational territory and may be perfectly willing to accept a non-compete for all other areas in the world. This will certainly alleviate concerns of neighboring franchisees.

4. Non-disparagement

A non-disparagement clause typically restricts what a current or former franchisee may say about his or her personal experience as a franchisee in the franchise system. This is, by the FTC Rule's definition, a "confidentiality clause."[53] If any franchisee has signed such a non-disparagement provision in the past three years, that fact must be disclosed in Item 20, although the franchisor need not provide who executed it or what the clause actually restricts. Must the franchisor disclose the non-disparagement clause in Item 3 and need it contain any more detail than is required by Item 20? A review of the Item 3 Top-50 Review disclosures reveals that none references

53. 16 C.F.R. § 436.1(c).

that a non-disparagement agreement was a material term of the settlement agreement.

B. *Encouraging Dismissals Before Ultimate Settlement*

As discussed in Section I, the language of the FTC Rule does not require disclosure of a settlement agreement if the franchisor is not held liable for certain Dishonesty Claims, and therefore disclosure might not be required if a franchisor first saw to the dismissal of any Dishonesty Claims that a franchisee made prior to settling. It is not hard to see the difficulty in convincing a franchisee to dismiss its Dishonesty Claims with no guarantee of favorable resolution of the remaining claims (when actually making such a promise could not be done without violating the FTC Rule, however artfully). This is particularly difficult if the Dishonesty Claims are not a mere afterthought, but actually have some likelihood of success and/or significant damages associated with them. These may be the claims, though, that the franchisor should be most prepared to fight to the bitter end. If the franchisee understood that the franchisor intended to refuse to settle any Dishonesty Claims, the franchisee might be convinced to dismiss the claims. Similarly, the franchisor might consider agreeing to settle the non-Dishonesty Claims in a generous manner, but could not tie such settlement to the franchisee's promise to release the remaining claims. In these examples, both parties might know the intentions of the franchisor and that they both could benefit from them. The trouble is whether either side is willing to risk its respective position without a commitment from the other side, which commitment would be difficult to read as anything other than an integral part of an agreement to settle the entire matter, thereby requiring disclosure. The author does not pretend to take a position on the legality or wisdom of attempting a resolution of the sort just described, and franchisors should be aware that such strategies may carry significantly more risk than they are worth. The safer route, if the desire not to disclose supersedes a rapid resolution of the matter, would be to focus litigation energies on dismissal of the Dishonesty Claims prior to considering settlement.

C. *Strategic Disclosure: Disclosing Arguably Non-Material Suits and Foregoing Summary Disclosure*

The FTC explicitly states that a litigation that is dismissed and settlement agreements that are favorable or neutral to a franchisor need not be disclosed because they are not material.[54] The Compliance Guide also limits reporting of material actions involving the franchise relationship to only the year that the franchisor files them. The FTC Rule states that a franchisor *may* use summary disclosure for certain franchisor-initiated suits. For both scenarios, franchisors may find instances in which more complete disclosure is preferred, even though it is not required. Particularly if a franchisor has a

54. 72 Fed. Reg. 15,479; Franchise Rule Compliance Guide, *supra* note 10, at 38.

handful of reportable cases in which the franchisor paid money to franchisees as a result of losing or settling a case, the franchisor should consider whether it helps to balance the pool of disclosures by fully disclosing similar litigation brought by franchisees that resulted in dismissal or a favorable settlement for the franchisor. Although the FTC Rule prohibits franchisors from including any material in addition to what it specifically requires or permits,[55] its language regarding dismissals ("need not" as opposed to "do not") implicitly permits inclusion and leaves the decision open to the franchisor.

For similar reasons, a franchisor may find it beneficial to provide a full description of franchisor-initiated lawsuits instead of the summary form that subsection (c)(4) of the FTC Rule permits. A franchisor can show to current and prospective franchisees alike how it vigorously protects its franchise system by, for example, aggressively pursuing parties who violate territory or noncompete restrictions. The franchisor may want favorable settlement terms disclosed to deter franchisees from testing the waters.

D. *Confidentiality Clauses in Settlement Agreements*

Although the instinct of counsel in drafting a settlement agreement is to provide for blanket confidentiality of the agreement and underlying negotiations and terms, counsel should craft the confidentiality provision carefully to minimize the impact of mandatory disclosure both by maintaining tight and specific control over a franchisee's reference to the settlement agreement and by reserving sufficient room for the franchisor to maneuver within the confines of the FTC Rule when disclosure is mandated or permitted.[56]

The most common exception to the blanket confidentiality clauses in franchise settlement agreements permits the franchisor to disclose the terms of the settlement agreement only as required by law or, more specifically, as required under the FTC Rule. This exception is sound practice because at least one court has refused to dismiss a franchisee's claim for breach of a settlement agreement when the franchisor disclosed the settlement terms as required by the FDD.[57] At the time of settlement negotiations, franchisor counsel should consider whether the franchisor would want to make use of the permissive disclosures even if the litigation technically did not have to be disclosed or could be relegated to summary disclosure. If so, language should be included in the settlement agreement to give sufficient latitude to do so.

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55. 16 C.F.R. § 436.6(d) ("Do not include any materials or information other than those required or permitted by part 436 or by state law not preempted by part 436."); 72 Fed. Reg. 15,515 ("This prohibition is necessary to ensure that franchisors do not include information that is non-material, confusing, or distracting from the core disclosures.").

56. *See generally* Martin G. Gilbert & Allan P. Hillman, *Settlements and Releases in Franchise Disputes: How to Make Sure It's Over When It's Over*, ABA 30th Ann. Forum on Franchising at W-6 (2007) (presenting a thorough discussion of settlement agreement language).

57. *See* Michael Gray & Julie Lusthaus, *Plowing New Ground: Litigating Non-Traditional FDD Disclosure Issues*, ABA 39th Ann. Forum on Franchising, at W-5, 12 (2016) (citing Caudill v. Keller Williams Realty, Inc., 2013 WL 5874761 (N.D. Ill. Oct. 31, 2013)).

The confidentiality provision in the settlement agreement should also discuss what a franchisee is permitted or required to say when asked about the franchisor, the franchise system, or its litigation. Especially in scenarios in which the franchisee will be listed in the FDD as either an Item 3 litigant or in the Item 20 list of former franchisees, the best answer to prospective franchisees and others inquiring about the litigation or reason for leaving the franchise system may not be to say nothing. Franchisors should establish in the settlement agreement the specific language that the franchisee (or both parties) may use to address such questions.[58] Although the settlement agreement must be reported in the FDD, it may (and probably should) prohibit the franchisee from pointing potential franchisees or anyone else to the FDD itself.

E. *Disclosing Ongoing Litigation to Minimize Settlement Disclosure*

Certain lawsuits must be reported under the FTC Rule while they are pending that, depending on the terms of a settlement agreement, would not be disclosed after they are resolved. For example, a lawsuit alleging fraud against the franchisor should be appropriately disclosed. If the lawsuit ultimately concludes with a settlement favorable to the franchisor (per the FTC's definition), the disclosure could be removed. In drafting the disclosure of the pending litigation, counsel should keep in mind how the matter might be resolved so the pending litigation disclosure is not overstated or understated.

IV. Conclusion

Item 3 disclosures are an important source of information for prospective franchisees. By keeping the FTC Rule's requirements in mind when drafting the franchise agreement and FDD, and while negotiating and settling disputes, franchisors and their counsel can ensure that a compliant, yet positive, representation can be made of the settlement agreements the franchisor has executed.

58. *See, e.g.*, Gilbert & Hillman, *supra* note 56, at 2 ("If asked about the disposition of this lawsuit, [franchisor] or [franchisee] may say that 'the case has been satisfactorily resolved' without violating this paragraph of this Settlement Agreement. [Franchisor] and [franchisee] agree that the only other permissible communication to any third party about this lawsuit and the settlement of this lawsuit is set forth in the statement attached hereto as Exhibit _____.").