THE FRANCHISEE LAWYER’S CHECKLIST:
WHAT EVERY FRANCHISEE LAWYER SHOULD KNOW

Julie Cowan Lusthaus
EINBINDER & DUNN, LLP

Peter Silverman
SHUMAKER, LOOP & KENDRICK, LLP

October 19-21, 2011
Baltimore, MD

©2011 American Bar Association
# TABLE OF CONTENTS

I. Representing Prospective Franchisees In Franchise Acquisitions ..............................1
   A. Obtain the Necessary Information to Assess Your Client’s Situation......................2
      1. Understanding Franchising ..............................................................................2
      2. What Are the Client’s Long-Term Investment Goals? ......................................2
      3. Registration and Proper Disclosure ..................................................................2
      4. Additional Research ...........................................................................................4
   B. Review the FDD, Franchise Agreement, and Related Documents ............................4
   C. Negotiating the Franchise Agreement ......................................................................11
      1. Factors Affecting Negotiations ........................................................................11
      2. What Terms to Negotiate? ..............................................................................12
      3. Who Will Negotiate? ......................................................................................12
      4. Arguments to Consider ..................................................................................12

II. Representing Franchisees Seeking Renewal ................................................................13

III. Representing Franchisees in Transfers ......................................................................14

IV. Representing Franchisees in a Dispute .......................................................................15
   A. The Information You Need ................................................................................16
      1. What Does your Client Want to Achieve? .........................................................16
      2. Documents to Review ....................................................................................16
   B. Does Your Client Have a Claim or Defense? .......................................................17
      1. An Initial Consideration: The Potential for Joining Franchisees .......................17
      2. The Franchise Agreement ...............................................................................17
         a. Encroachment ................................................................................................18
         b. Advertising Fund .......................................................................................18
c. Rebates ......................................................................................................19

d. Sole Supply ................................................................................................19

e. Failure to Support .......................................................................................20

f. Quality Control............................................................................................20

g. Fairness Considerations.............................................................................20

3. Does the Client have a Disclosure Claim or Defense?........................................20

a. Disclosure...................................................................................................20

b. Financial Performance Representations (FPRs) ........................................21

c. Initial Start-Up Costs...................................................................................22

d. Other Misrepresentations ...........................................................................22

e. Disclaimers ..................................................................................................22

4. Statutory Violations .............................................................................................23

a. Improper Termination Under Relationship Laws ........................................23

b. Equal Protection .........................................................................................23

c. Little FTC Acts ............................................................................................23

C. Options for Business Resolution ...............................................................................24

1. System-wide Considerations ........................................................................24

2. Item 3 Disclosure Sensitivities .....................................................................24

3. Franchisor’s Broader Business Strategy .........................................................25

4. Equitable Grounds for Cure ...........................................................................25

5. Negotiating Termination ...............................................................................25

a. Liquidated Damages/Lost Future Profits ....................................................26

b. Buy Time/Ease the Pain ...........................................................................26

c. The Bank ....................................................................................................26

D. Litigation Options: Analysis and Creating Realistic Expectations ....................26
1. Cost/Benefit Calculation ................................................................. 26
2. The Trademark License Under the Lanham Act .......................... 27
3. Non-Compete Injunction ................................................................. 27
4. Franchisor’s Right to Buy Business ........................................... 28
5. Mediation ..................................................................................... 28
6. Arbitration ................................................................................... 30
7. Choice of Venue ......................................................................... 31
8. Choice of Law ............................................................................. 31
9. Contractually-Shortened Limitations Periods .......................... 32
10. Attorneys’ Fees .......................................................................... 32

CONCLUSION ......................................................................................... 32

CHECKLIST .......................................................................................... 33
Representing Franchisees

Franchisees often call their lawyers in a crunch: I need to negotiate concessions in the franchise agreement and sign it in three days, or I’ll lose my chosen territory. Or in a crisis: I just got a termination letter.

Franchisee lawyers need tools to respond quickly and well to these situations – a checklist of the information they need from the franchisee and of the legal issues to consider. Franchisee lawyers also need to understand the business of franchising because negotiating franchise agreements or resolving franchise disputes requires finding the business solution that makes the best sense under the circumstances.

This paper provides you with an overview of the legal and business issues for negotiating franchise agreements and their renewal and transfer, and for resolving franchise disputes. We range wide rather than deep, and aim to provide a resource that is helpful to attorneys new to franchising and to those who are experienced.

If you are new to franchising, we offer a word of caution. Franchisees often come to their lawyers at the last minute, under very difficult circumstances, and with little money. They may be ready to sign an agreement that will govern their business for the next twenty years, or may be facing termination that will ruin them economically. To represent franchisees well in these circumstances, you need knowledge and judgment that takes many years to develop. While this paper presents an overview of the issues to consider in these circumstances, it is in no way a substitute for the depth of knowledge and experience needed to represent franchisees well. If you are called on in a crisis and you do not have this level of knowledge and experience, plan to put in the extra time to consider all issues thoroughly or to bring on someone who has that experience to help you and from whom you can learn. Failing to do so hurts franchisees and is an invitation to malpractice.

I. REPRESENTING PROSPECTIVE FRANCHISEES IN FRANCHISE ACQUISITIONS

When buying a franchise, a prospective franchisee retains counsel for numerous reasons. Sometimes counsel is sought to advise her on the legal aspects of the detail and to ensure that the franchise opportunity is right for her. Other times, she wants to proceed regardless of the deal’s terms, and she hires counsel simply to “bless the deal” or because a friend or family or franchise representative told her to have an attorney review the documents. Regardless of the prospective franchisee’s motivations, franchisee counsel serves the important role of educating her so that she fully understands what he or she is “getting into.”¹ This section of our paper discusses the steps you should take and the items you should consider in advising her and negotiating on her behalf.

¹For an in depth discussion on counseling franchisees, see Andrew Selden & Rupert Barkoff, Fundamentals of Franchising, Chapter 7 (3d ed. 2008).
A. Obtain the Necessary Information to Assess Your Client’s Situation

To help your client determine whether she is well-suited for franchise ownership and the particular franchise offering, you need to not only review the FDD\(^2\) and related agreements to advise her on their terms, but you should also provide her with a proper understanding of franchising, review her investment goals and ascertain whether she received proper disclosure.

1. Understanding Franchising

For the prospective franchisee, franchising may be a brand new world. If so, you will need to advise her about franchising generally, and the role of the franchisor and franchisee in the operation of a franchise. Franchising is intended to be a long-term relationship in which the franchisee must be prepared to give up some independence in return for the right to operate a franchise under a model and a trademark controlled by others. Franchising is often best suited for those looking to buy a business that is a turn-key operation where they can expect to follow a predetermined system in order to achieve success.

A client with business experience, however, may be able to operate the same type of business just as well independently, without the costs and restraints of franchising. The client should consider whether she would be willing to follow someone else’s rules and to implement system standards even if she does not agree the standards are in her best interest. If not, she may be better suited to independent ownership and control over her business.

2. What Are the Client’s Long-term Investment Goals?

Some prospective franchisees seek a business opportunity where they will manage the day-to-day operations of one franchise unit for many years to come. Others want to buy into a franchise system with the goal of multi-unit ownership. These clients seek to either acquire area development rights from the beginning of the franchise relationship or buy one unit with the hope of opening additional units if the first is successful. The client should understand the differences in these choices, and whether the client’s goals mesh with the franchisor’s development model.

3. Registration and Proper Disclosure

The Federal Trade Commission rule on franchising (FTC Rule)\(^3\) requires that a franchisor provide a copy of its FDD to a prospective franchisee. The FTC Rule does not require a franchisor to register its FDD with the FTC. A number of states, though, have enacted laws requiring registration of the FDD in that state before the sale of franchises within the state.\(^4\)

\(^2\)Before July 1, 2007, the franchisor’s disclosure document was referred to as a Uniform Franchise Offering Circular, or UFOC. The nomenclature was changed to Franchise Disclosure Document, or FDD, by the Federal Trade Commission’s amendments to its Franchise Rule, 16 C.F.R. §436. In this paper, we will refer to all disclosure documents as FDDs.

\(^3\)16 C.F.R. Pt 436 (2008) available at http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr;sid=33b98d5847cf9285fa3c8617bde45694;rgn=div5;view=text;node=16%3A1.0.1.4.54;idno=16;cc=ecfr (last visited July 19, 2011).

Some states, such as New York, require resident franchisors to register in that state even if they are not selling to a resident in that state and the franchise will be not operated in that state. Other states do not require actual registration of the documents but do require franchisors to file a notice with the state before the sale of a franchise within the state. For example, Florida and Michigan require an annual notice to be filed. Nebraska and Texas require a one-time filing. Finally, some states have enacted business opportunity statutes that may apply to the sale of a franchise within that state. To determine whether a franchise offering was properly registered by the franchisor, you can check with the appropriate state administrator responsible for franchising/registration in that state.

Under the FTC Rule, disclosure must be provided at least fourteen calendar days before the prospective franchisee signs a binding agreement or makes a payment to the franchisor (or its affiliates) in connection with the proposed franchise sale. In addition, certain states have disclosure laws as well. Some state laws contain the same timing requirements as the FTC Rule. Other states, such as New York and Rhode Island, require a franchisor to provide a prospective franchisee with its FDD at the earliest of: (i) the first personal meeting between the franchisor or its agent and the prospective franchisee to discuss the franchise; (ii) ten business days before the signing of a binding agreement; or (iii) ten business days before the receipt of any consideration in connection with the sale or proposed sale.

To determine whether your client has been properly disclosed, inquire when she received the FDD, whether she has made any payment, and whether she has signed any agreements. If registration or notice is required, check whether the franchisor has registered or provided notice. If not, or if your client was not properly disclosed, it is the franchisor’s violation, not your client’s, and she may still proceed with the opportunity. The franchisor’s failure to comply with franchise laws and regulations, however, should be cause for concern. It could be a sign that the franchisor is more focused on the business of selling franchises than on the requirements of selling them lawfully. It could also be an indication of an inexperienced franchisor with lack of knowledge of relevant laws or lack of control over its employees handling disclosure. Either way, if the franchisor has failed to comply in connection with the offering to the client, the franchisor likely failed to comply with the law and regulations in offerings to other franchisees. Those failures could result in litigation against the franchisor, which could affect the brand and distract the franchisor from focusing its efforts on supporting the brand and franchise system.

---

9 16 C.F.R. §436.2(a).
4. **Additional Research**

You should encourage your client to research information beyond the franchisor’s FDD. The franchisor’s marketing materials and website often provide useful information about the opportunity. She can review FDDs and on-line information for competitive franchises, and can visit the franchised and competitive establishments. She can also contact other franchisees to learn about their experience.\(^{12}\) As indicated in section I.B below, the franchisor is required to provide prospective franchisees with contact information for former and current franchisees. This information is required to be provided by regulators specifically so that prospective franchisees can learn about the franchise system from these individuals. Conducting all of this due diligence will help her determine if the franchise offering is the right opportunity.

**B. Review the FDD, Franchise Agreement, and Related Documents**

Once you have gathered the relevant facts and documents, you should review the FDD, the franchise agreement, and related agreements with your client. This will help you ensure that your client understands the details of the franchise offering and also identify areas of the franchise agreement that she may want to try to negotiate.

The FDD contains 23 items of information that the FTC has determined are important to assist a prospective franchisee in adequately evaluating the franchise offering.\(^{13}\) The FDD is not a complete or comprehensive description of the franchise offer and the FDD cannot distinguish between good and bad investments.\(^{14}\)

The FDD is not an agreement between the franchisor and franchisee. The relationship between the franchisor and franchisee is governed by the franchise agreement, which should be attached to the FDD as an exhibit. Your client and you should carefully review these documents to ensure that she fully understands her rights and obligations as a franchisee.\(^{15}\)

Item 1 of the FDD is intended to describe the franchisor and any parents, predecessors or affiliates of the franchisor, as well as the franchise being offered. Item 2 describes the business experience of the franchisor and its officers and all individuals who will have management responsibility relating to the sale or operation of franchises. Important questions to consider are whether the individuals identified in Item 2 have experience operating a unit of the type being franchised. Do they have experience training others to operate a unit? Do they have experience operating a franchisor? Sometimes prospective franchisees are attracted to a particular franchise offering because of the franchisor’s current management style. Your client should understand that management personnel will likely change during the course of the franchise relationship.

\(^{12}\)Former and current franchisee contact information is provided in Item 20 of the FDD.

\(^{13}\)The requirements set forth in this Section are gathered from the North American Securities Administrator Association’s 2008 Franchise Registration and Disclosure Guidelines (Amended and Restated UFOC Guidelines) available at [http://www.nasaa.org/content/Files/2008UFOC.pdf](http://www.nasaa.org/content/Files/2008UFOC.pdf) (last visited July 14, 2011).


\(^{15}\)For an extensive discussion about common clauses contained in franchise agreements, see Kerry Olson, Robin Spencer & Larry Weinberg, *The Annotated Franchise Agreement*, American Bar Association, Thirty-third Annual Forum on Franchising (2010).
Items 3 and 4 describe certain litigation and bankruptcy information about the franchisor and any person described in Item 2. These items identify whether the franchisor or anyone listed in Item 2 has been party to any material civil action involving the franchise relationship in the last fiscal year, has been convicted of a felony in the last ten years, or has been held liable in a civil action in violation of a franchise law or involving allegations of fraud. This information will likely prove informative about the franchisor and the system. Certainly, if there are many actions identified in which claims for fraud or franchise statutory violations were asserted against the franchisor or its officers, your client should proceed with great caution. If there are numerous actions which involve similar contract claims, such as those involving the advertising fund, this may be an indication that there is (or was) a problem in the system. If possible, you may want to review relevant court records and contact the identified franchisees or their counsel to get more information about the disputes. Your client will also learn whether the franchisor or any of the persons identified in Item 2 have filed for bankruptcy.

Item 5 identifies the fees that, before the franchisee opens for business, the franchisee will pay for services or goods received from the franchisor or any affiliate. This item includes the initial franchise fee, which is ordinarily a one-time fee paid by the franchisee for the right to open the franchise. This fee is typically nonrefundable and may or may not be negotiable depending, in part, on the maturity of the franchisor. The amount of the initial fee depends on the industry and can run from a few thousand dollars to tens of thousands of dollars. This item will also indicate other fees and whether the franchisee must purchase advertising materials, software or other inventory from the franchisor or its affiliates.

Item 6 identifies all other fees that the franchisee will be required to pay to the franchisor or its affiliates during the franchise term. This item is helpful for determining additional revenue the franchisor will earn from the operation of the franchise. Ongoing fees paid to the franchisor or its affiliates typically include royalties and advertising fees, though they may also include such items as license fees for the use of certain computer software. Your client should also understand the basis for calculating ongoing fees. Often these fees are based on the gross sales from the operation of the franchise without deduction for costs or expenses. These fees are “taken off the top” and are required to be paid even if the franchisee is operating at a loss.

The fees identified in Items 5 and 6 will be contained in the franchise agreement and those provisions of the agreement should be reviewed for possible areas of negotiation. For instance, there may be a minimum amount required to be paid for royalties if gross sales do not reach a certain level. Not only would this provision require the client to pay royalties without regard to revenues, it can serve as a method for calculating damages if the client is unsuccessful and the franchise is terminated. You may want to seek to negotiate this provision.

Item 7 provides an estimate of the franchisee’s initial investment for an identified initial period before the franchisee begins operating and after opening the unit. Such period usually includes expenses to be incurred for at least three months or a reasonable period for the industry. Clients should be cautioned not to rely too heavily on Item 7 information and to conduct due diligence on the topic. This is in part because Item 7 is only intended to be an estimate and very likely will not include all investment expenditures. In addition, Item 7 information may not be accurate for the franchisee as the franchisor may not be familiar with costs associated with developing a unit in the franchisee’s geographical area or the franchisor

may simply not have updated Item 7 information from a prior FDD. Clients should be encouraged to “shop the numbers” listed in Item 7 and determine what investment costs would be for those items where the franchisee intends to operate.

Item 8 requires disclosure of the franchisee’s obligations to purchase or lease goods or services from the franchisor or under its specifications, and these obligations will also be contained in the franchise agreement. If the franchisor or its affiliate is the only approved supplier for a required purchase, the franchisor will earn additional revenue from the operation of the franchise. Indeed, franchisors often use these required purchases to treat their franchisees as “profit centers.” Where the franchisor earns revenue from required franchisee purchases, this item will disclose the franchisor’s revenue earned from the franchisees’ required purchases and leases. Additionally, the franchisor must disclose whether it receives rebates or other payments from designated suppliers as a result of the franchisee’s required purchases.

In addition to fees revealed in Item 8, the franchise agreement may contain “hidden” costs and expenses that are not expressly stated in the FDD. These include expenditures for required modifications or upgrades to the franchise or location, although the requirement to upgrade the franchise or location should be stated in Item 8. Often, the franchisor has discretion to require franchisees to comply with changes to system standards. These may include, for example, refurbishing the location, acquiring a new computer system, or discontinuing the sale of certain inventory. There is often no cap on the costs franchisees may incur when implementing these changes. Prospective franchisees should understand that the franchisor can require them to incur these expenditures at any time. It can be helpful to review a client’s pro forma or business plan to ensure that it provides for these hidden fees. In addition, one possible area of negotiation is to seek to cap these fees. For instance, you may want to propose that costs for upgrades or modifications to the franchise will not exceed a certain dollar amount within a certain time period. If negotiation on this point is successful, the client will be better equipped to estimate future expenses that are otherwise incalculable.

Item 9 contains a table that lists the franchisee’s principal obligations under the franchise agreement and certain important provisions of the franchise agreement. Generally, this table serves as a reference point indicating where in the franchise agreement those obligations and provisions are contained. Item 9 will also indicate if the franchisor is entitled to recover liquidated damages. Some franchise agreements provide for liquidated damages for the franchisor if the franchise agreement is terminated pursuant to its terms. Although often difficult to eliminate, you may want to seek to negotiate a cap on the liquidated damages amount or other damages the franchisor can obtain if the franchise agreement is terminated. Bear in mind that state law may affect whether a liquidated damages provision will be enforceable. Before you go to the mat seeking to negotiate this provision, you may want to review and consider the enforceability of such a provision under relevant state law.

Item 10 identifies whether the franchisor provides financing.

Item 11 describes the assistance the franchisor will provide, the computer system the franchisee needs to purchase, and the franchisor’s advertising and training program. These

---


18 Minn. R. Part 2860.4400 (West 2011)
obligations should also be contained in the franchise agreement. Focus closely on the assistance requirements as that is all that the franchisor is required to do. Item 11 also importantly identifies the typical length of time between the signing of the franchise agreement and the opening of the franchisee’s business.

Item 12 describes the franchisee’s territorial rights, if any, and this is also addressed in the franchise agreement. Some systems provide no territorial protection and the franchisor has the contractual right to permit another unit (franchised or company-owned) to open adjacent to the client’s location. If this is the case, it is critically important for your client to understand that the franchisor may do so. Ensure that your client understands that she should not rely on promises by franchise sales personnel that the franchisor “would never do that.” If there are protections, review them carefully. For example, if the franchise agreement provides the franchisee with a protected territory of three miles from her location, how are those miles calculated? Is it as the crow flies or as a car drives? If the protected territory is determined by population, what happens if the population increases in that area? Can the franchisor reduce the territory?

Significantly, the territorial protection may only prevent the franchisor or another franchisee from opening a unit within the franchisee’s territory. The franchisor may still have the right to sell products or services (the same as those sold by the franchisee) in the territory through alternative methods of distribution. For example, the franchisor may sell products over the Internet, through supermarkets, wholesalers, etc. You may want to negotiate certain protections for your client related to territory, such as the right to service customers located within the territory who place orders over the Internet, or a right of first refusal to open a unit in an adjacent territory (or within a certain geographic area if no territory is provided).

Items 13 and 14 address the franchisor’s intellectual property and should identify who owns the trademarks, patents, and copyrighted information used by the franchisees. Item 15 will identify whether the franchisee has an obligation to participate in the actual operation of the franchise and Item 16 identifies restrictions on what the franchisee may offer for sale from the franchise.

Item 17 contains a chart and refers to various sections in the franchise agreement. This item also indicates certain rights and obligations such as the term of the agreement, renewal rights, transfer rights, termination rights, and dispute resolution. Give these sections particular scrutiny as they affect not only your client’s investment, but also your client’s ability to resolve disputes with the franchisor.

Term. The right to operate the franchise is likely limited to a set term. An initial franchise term usually lasts between 5 and 10 years. The client should consider how much time she will need to recoup her initial investment and whether the term of the franchise agreement is long enough to permit such recovery.

Renewal. The question then arises as to what happens when the initial term expires. Will the franchisee have a right to renew the franchise and if so, for how long and on what terms? Franchise agreements often provide franchisees with a right to renew for one or two additional terms. The franchisee, however, usually receives only a right to renew the franchise, but not the identical franchise agreement she originally signed. This is significant because franchisors will often require the franchisee to sign the “then-current form of franchise agreement” upon renewal. The then-current form of franchise agreement may contain more
onerous terms (including increased fees) than the original franchise agreement. Other changes may also be incorporated into a then-current agreement, including changes to territory.

Consider negotiating the renewal terms at the same time that you are negotiating the initial agreement. You may want to seek additional renewal periods or to make the renewal periods unlimited. Perhaps it is important to your client that on renewal, the royalty fee is not increased or the territory is not changed. If you successfully negotiate these terms before execution of the initial franchise agreement, your client will be more informed as to what her rights and obligations will be when the franchise agreement expires.

Transfer. Franchisors often have an unlimited right to sell or transfer the franchise system, which includes all the franchise agreements, whereas a franchisee’s right to sell or otherwise transfer are usually limited. Typically, transfers by the franchisee require the franchisor’s consent. The transferee must meet the franchisor’s requirements and often must sign a then-current form of franchise agreement. This can affect a franchisee’s ability to sell because the franchisee will not be able to offer the proposed buyer the same franchise agreement under which the franchisee has been (presumably) successfully operating. Further, franchisors often require that franchisees (and transferees) release all claims they may have against the franchisor as a condition of receiving the franchisor’s consent to the transfer. Thus, if the franchisee is seeking to sell its business, but also has a claim against the franchisor for, say, misuse of the advertising fund, the franchisee may have to waive that claim in order to sell the franchise. Finally, note whether the franchisee is required to remain liable for the franchisee’s obligations after a transfer. If so, she may be forced to guaranty the buyer’s obligations to the franchisor rather than being able to walk away from the relationship.

Termination. Prospective franchisees sometimes assume that if the business is not successful, they can cut their losses, stop operating, and terminate the franchise agreement. Often, this is not the case. Franchisees rarely have a contractual right to close their doors if the franchise is not successful. While the franchise agreement may provide the franchisee with a right to terminate the franchise agreement if the franchisor is in material default of its contract obligations, there is often little opportunity for franchisees to exercise this right because the franchisor does not have many contract obligations. Try to negotiate a right to terminate if the franchise is unsuccessful. While franchisors do not often concede on this point, the franchisee may have leverage to negotiate this if the franchisor is new or seeking to open a new region.

Conversely, the franchisor often has extensive rights to hold the franchisee in default and terminate the franchise agreement. The default and termination provisions of the franchise agreement should be carefully reviewed to determine the different grounds for default and whether the franchisee will have a right to cure particular defaults prior to termination. You should also determine whether any standards are wide-ranging, such as a right to terminate for violation of “any law.” Try to negotiate these provisions to provide your client clear standards, reasonable notice, and a reasonable opportunity to cure. Note also that, notwithstanding the franchisor’s contractual rights to terminate the agreement, franchisees may be protected by an applicable state franchise relationship law, which can limit the franchisor’s ability to terminate the relationship.

---


Dispute Resolution. Dispute resolution provisions in the franchise agreement may include provisions addressing venue, choice of law, limitations periods for bringing suit, damages limitations, procedural limitations barring class or consolidated actions, mandatory mediation and whether disputes are determined by arbitration or litigation. You may want to seek to negotiate these provisions, though franchisors rarely agree to change them.

Item 18 discloses whether the franchisor uses any public figures to advertise the franchise system.

Item 19 contains any financial performance representations (“FPRs”) given by the franchisor. Under the FTC Rule, franchisors are limited as to how this information can be provided to prospective franchisees. Generally, FPRs include any information about the actual or potential financial performance of franchised or company-owned units. If the franchisor provides FPRs, they must be in the FDD and follow strict guidelines to insure they are reasonably based, accurate and not misleading.

In addition to reviewing Item 19, you should ask your client whether she received any other financial information from the franchisor. The franchisor may have provided the information in marketing materials or its salesman may have written it on a cocktail napkin. FPRs provided outside the FDD violate the FTC Rule and, perhaps, state disclosure laws. If the franchisor has provided FPRs outside the FDD, your client should understand the implications of the violation. No safeguards exist that the representations are reasonably based, accurate and not misleading. Further, the franchisor probably provided similar information to other prospective franchisees, who may have relied on it to the detriment of the system. Also, the violations can result in litigation against the franchisor or even regulatory actions by the FTC (or state regulators), which could impact the brand and distract the franchisor from focusing on the business of the franchise.

Item 20 provides information about existing and former outlets, including the name and contact information of current franchisees as well as certain former franchisees. This information is valuable and you should encourage your client to contact as many people identified in Item 20 as possible. These current and former franchisees are the greatest source of information about the franchise opportunity, the franchisor, and the industry. Questions to ask these individuals include:

- Are you glad you bought the franchise?

---

21 Before July 1, 2007, the franchisor’s representations about financial performance were referred to as earnings claims. In the amendments to the Franchise Rule, the FTC changed this nomenclature to financial performance representations. In this paper, we will refer to all representations about financial performance as financial performance representations or FPRs.

22 16 C.F.R. §436.5(s).

23 Id.

• Did you consider any other franchises before you bought this one? If so, why did you choose this opportunity?

• Has the franchisor provided you with all of the assistance it agreed to provide?

• Was the training adequate?

• Does the franchisor seem interested in helping you achieve success or is it more interested in profiting from the operation of your franchise?

• Is your business successful?

• How long did it take you to break even?

• Knowing what you now know, would you buy this franchise if you had the opportunity to do it over? 25

Any information received from former and current franchisees is valuable information and the opportunity to speak with current franchisees creates an opportunity to meet future fellow franchisees. Former franchisees can tell your client why they left the system and possibly the things that management and current franchisees would not want to share with a prospective franchisee. Of course, not all current and former franchisees will be responsive or even honest in their answers, and their silence is also informative. Perhaps current franchisees do not want to disclose problems in the system. Perhaps they are not attaining the success they hoped to achieve. Also, some former (and current) franchisees may be bound by a confidentiality agreement as a result of a settlement or otherwise, and so may be precluded from speaking about the franchisor. Still, speaking with both groups can provide the client with insider knowledge not otherwise attainable about the system, the franchisor or other franchisees.

Item 21 contains the franchisor’s financial statements for the previous two fiscal years. If the client is not a sophisticated businessperson or you are not skilled in reviewing financial statements, encourage your client to have the statements reviewed by an accountant with knowledge in the particular industry and preferably in franchising. This should provide the client with some knowledge about the franchisor’s financial status. A struggling franchisor may not be able to support and expand the system, and may seek more fees from franchisees to strengthen its finances.

Item 22 contains copies of all proposed agreements regarding the franchise offering, including the franchise agreement. Although the FDD contains important information about the franchisor and the franchise offering and should be reviewed, it is the franchise agreement that governs the relationship between the franchisee and franchisor. It is essential that the client understand her rights and obligations under the franchise agreement, and you are likely to spend most of your time reviewing and advising her on this document.

Of course, there are additional agreements that may be contained in Item 22 and these should be reviewed as well. One agreement that is often included is a guaranty. Franchisee counsel often advise clients to form a business entity to execute the franchise agreement and operate the franchise. This helps protect the individual client from personal liability.

Franchisors, however, often require the individuals to sign a guaranty of the franchisee’s obligations. The guaranty is an important agreement to consider negotiating. While most franchisors will not agree to eliminate the guaranty altogether, they may agree to a limitation on personal liability. One approach is to offer a “good guy” guaranty (similar to that with a real estate lease). Here, the client would guaranty the obligations that the franchisee incurred while operating the franchise along with certain obligations upon termination such as ensuring de-identification of the franchised location and compliance with the non-competition provisions. Or you may simply seek a cap on the amount of the guaranty.

Another agreement that franchisors often require the franchisee to sign is a confidentiality and non-competition agreement. This agreement obligates the franchisee’s owners (and often managers) to be bound by the franchise agreement provisions on confidentiality and non-competition. Most franchise agreements preclude the franchisee (and its owners) from operating a competing business during the operation of the franchise. This is understandable as the franchisor wants to ensure that the franchisee is devoting its efforts to the operation of the franchise, and is not using the franchisor’s trade secrets and business methods to compete with the system. Franchisors also often want to stop former franchisees (and their owners) from operating competing businesses after termination or expiration of the franchise agreement. Provisions vary as to geographic limitations, time restrictions, and how they define the scope of what is a competitive business. If your client operates businesses within the industry, or intends to continue working in that industry after the franchise is terminated or expires, you should negotiate these provisions.

Item 23 contains the receipt for the FDD.

C. Negotiating the Franchise Agreement

Neither the FTC Rule nor state franchising laws prohibit the franchisor from negotiating the franchise agreement with the franchisee. The FDD furnished to a prospective franchisee serves as the franchisor’s initial offer. The franchisee may attempt to negotiate better terms. The franchisor is free to refuse to negotiate, except in Virginia, which may require the franchisor to negotiate with the prospective franchisee, though the franchisor is not required to agree to any proposed terms. California is the only state that requires franchisors to disclose to future prospective franchisees certain negotiated changes made to a franchise agreement.

1. Factors Affecting Negotiations

Certain factors affect a franchisee’s ability to negotiate the franchise agreement. These include the franchisor’s size, financial stability, and growth strategy as well as the franchisee’s desirability, wealth, and experience. Some franchisors are not willing to negotiate, and they may have valid reasons for refusing to do so. The franchisor may refuse to negotiate simply because it has a desire to keep the provisions in the franchise agreement uniform throughout the system. Uniform franchise agreements are easier for the franchisor to manage enforcement. Refusing to negotiate will also keep other franchisees from becoming resentful as

another franchisee will not have negotiated a better deal.29 Some franchisors will agree to negotiate, but will not ultimately make any changes of substance, agreeing instead to minor modifications so as to allow the franchisee to feel as though she has won concessions.

If, however, the franchisor is a start-up franchise or is looking to expand to a new geographic area, the franchisor may be more willing to negotiate. Also, if the franchisee is looking to acquire a multi-unit territory and will be making a larger investment, the franchisee may have greater leverage than would a franchisee buying a single unit.

Only one thing is certain -- the franchisor will not modify the agreement unless you ask. Even if the franchisor refuses, efforts to negotiate will provide your client and you with additional interactions from which to learn about current franchisor management. These interactions can provide greater insight about the people with whom your client is considering having a long-term franchise relationship.

2. What Terms to Negotiate?

Once you and your client have decided to attempt negotiations, you need to determine the best way to approach the franchisor. It is helpful to provide counsel for the franchisor with a list of provisions you want to discuss. Rarely will you be refused an opportunity to discuss specific items but you may find resistance to going through the franchise agreement paragraph by paragraph. Sending over a rewrite of the entire agreement will likely result in rejection by the franchisor’s lawyer of all of your requests, even the legitimate ones, out of hand. Depending on the situation, proceeding with a laundry list of proposed changes may be best. Alternatively, a better approach may be to try to negotiate only your client’s “deal breakers.” In casting a term as a deal-breaker, recognize that some provisions may be deal breakers for the franchisor as well. For instance, many franchisors are resistant to eliminating the guaranty. Others may not agree to provide the franchisee with a right of first refusal for a new territory.30 No matter what provisions you are seeking to negotiate, consider whether you also want to ensure that those negotiated changes are incorporated into any renewal terms. For example, if you are able to obtain a cap on the costs your client will incur making modifications to her unit, you probably want that cap to remain for the renewal term as well.

3. Who Will Negotiate?

Determine who will negotiate. If the franchisee is a sophisticated business person, she may want to negotiate directly with the franchisor. If not, it may make sense for you to conduct the negotiations. Ultimately, you will need to be involved in approving any language changes.

As to mechanics, franchisors rarely modify the actual franchise agreement. Rather, they usually make the changes in an addendum to the franchise agreement. Sometimes the franchisor and its counsel will want to retain control over the document and will draft it. Other times, the franchisor (or its counsel) will require the franchisee to incur the drafting costs by having counsel for the franchisee draft the addendum.

---

29 Andrew Selden & Rupert Barkoff, Fundamentals of Franchising at 301 (3d ed. 2008).

30 For a “franchisee’s wish list” of provisions to negotiate, see Lawrence Ashe & Harris Chernow, Negotiating Franchise Agreements: the Franchisee’s Perspective at 10 (2000).
4. Arguments to Consider

Whether you or the client is requesting changes to the franchise agreement, make valid arguments as to why the changes are being sought. Is it a question of management? For instance, the franchisor may tell the client a particular change is not needed because the franchisor does not enforce the agreement provision. But what if new management takes over? If the change is not in writing, your client will likely not be protected. Or, is it a question of fairness? For instance, where the franchisee has only a year to commence litigation without waiving a claim, maybe the franchisor should have the same limitation. Whatever the reason, the franchisor is more likely to consider a modification if it understands the franchisee’s concerns.

II. REPRESENTING FRANCHISEES SEEKING RENEWAL

Once the client has acquired the franchise and is (hopefully) operating successfully, she may want to renew the franchise. As discussed above, franchise agreements are usually for a set term of years. On expiration, the franchisee may have a right to renew the franchise if certain conditions are met. Negotiating the terms of renewal can be conducted at the time the initial franchise agreement is negotiated or at the time of renewal. If your client is seeking to renew the franchise, the first step is to review the initial franchise agreement and determine not only whether she has a right to renew but also the conditions for renewal. Initially, review her requirements for notifying the franchisor that she intends to exercise that right. Franchisors can require as much as a year's notice and the franchisee should plan early if she is seeking to renew the franchise. Failure to provide timely notice may bar the franchisee’s right to renew, though the franchisor is likely to be inclined to renew the franchise for a successful franchisee.

Other renewal conditions will likely include the requirement that the franchisee was in substantial compliance with her obligations under the initial franchise agreement during its term. This is not surprising as it benefits the franchisor as well as the system if the franchisor is not required to renew an unprofitable or uncooperative franchisee. If the client has not generally been compliant under the franchise agreement, she may have lost her contractual right to renew the agreement.

Often, the franchisee will be required to sign the “then-current” form of franchise agreement. Franchisors often update and revise their franchise agreements over time and the franchisor will want to ensure that the franchisee will be operating under the system as it then exists. If your client is required to sign the new franchise agreement, compare it to the previous agreement so she can fully understand the different terms. You can also discuss areas of negotiation as you would if your client were seeking to sign the initial franchise agreement (see section I.B above).

Renewal is also often conditioned on meeting the franchisor’s then-current requirements for appearance and systems. This can involve substantial renovations and costs. Sometimes,

---

31For an in depth look at franchise renewals, see Robert Einhorn and Craig Tractenberg, Renewals and Conditions on Renewal, American Bar Association Twenty-seventh Annual Forum on Franchising (2004).

32Id. at 1.

33Claudia Koeppel Levitas and Allan Hillman, Hot Topics on Transfer and Assignment By Franchisees, American Bar Association Twenty-eighth Annual Forum on Franchising (2005).
a franchisor will permit the franchisee to conduct the renovations over time rather than before renewing the franchise. If these expenditures are a concern to your client, consider proposing a time frame for completion that would enable her to proceed with renewal while implementing changes. Similarly, the franchisee may be required to participate in additional training in order to renew the franchise so that she learns new methods of operation required in the system.

The franchisee will also likely have to pay a renewal fee rather than an initial franchise fee. Often the renewal fee is less than an initial franchise fee. This fee may be a flat fee or a percentage of the then-current initial franchise fee.

Typically, renewal is conditioned on the franchisee’s executing a release of the franchisor, which waives all existing claims against the franchisor. This covers individual and systemwide claims. The requirement to sign a release is often a difficult provision to negotiate, though you may be able to carve out an ongoing dispute from the release.

Some states have relationship laws that limit the franchisor’s right to refuse to renew. Generally, those states require that the franchisor have good cause for not agreeing to renew. Additionally, some states require the franchisor to provide certain written notice to the franchisee of its intent to not renew. In some states, anti-discrimination statutes place limits on the franchisor’s ability to not renew.

To the extent your client wants to negotiate renewal terms or the renewal agreement, many of the issues addressed in section I.C will apply. If your client is a successful franchisee, she is likely to have more leverage in negotiating changes than before she began her tenure as a franchisee. Understand, however, that the first step is to ensure that your client meets any contractual obligation to provide the franchisor with notice of her intent to renew. Otherwise, she may waive that right. After that, the process will likely be dictated in large part by the renewal conditions set forth in the initial franchise agreement.

III. REPRESENTING FRANCHISEES IN TRANSFERS

A related area of representation arises if your client wants to transfer her franchise to a third party. The franchise agreement governs whether and to whom she can transfer her franchise. Most agreements permit a franchisee to transfer her franchise so long as she and the transferee satisfy certain conditions. Many of those conditions are similar to those required for renewal. As with renewal, the franchisee will have to provide the franchisor with certain notice of her intent to transfer. If she is seeking to do so shortly before the end of the term, she should be careful to take all necessary steps before expiration. If the franchise agreement expires, she will no longer have a franchise to transfer.

The franchisee is likely to be required to pay all outstanding debts to the franchisor, bring the franchised location up to current standards, and pay a transfer fee. The new franchisee will have to sign the then-current form of franchise agreement. Whether the  

---

franchisee or transferee pays the transfer fee and incurs the costs for upgrades will be a factor of negotiations between the selling franchisee and the buyer.

The transferee must meet the franchisor’s requirements for new franchisees. These include financial requirements; the satisfactory completion of any required training; and assurance that the transferee has no interest in a competitive business. The franchisor will also probably require the transferee to execute a release of claims against the franchisor.

The franchisor may also require the franchisee to remain liable for the transferee’s obligations. Even if the franchisor does not require this, the franchisee should obtain a release from future liability to be sure her liability does not continue as a matter of law. 38

The franchisor may have a right of first refusal to purchase the interest to be transferred. If so, the franchise agreement indicates whether the franchisor must buy the interest on the same terms as offered by the transferee or whether it can substitute terms such as a note for cash. The franchise agreement generally requires the franchisee to provide the franchisor with a good faith offer to transfer the franchise, including all material terms, and give the franchisor a specified time in which to exercise its right to purchase.

Some states have relationship laws that limit the franchisor’s right to deny consent to a transfer. 39 For instance, some statutes provide that a franchisor must have good cause to deny consent. 40 Other states prohibit the franchisor from denying consent for a transfer if the transferee meets the current requirements for new franchisees. 41

If your client is seeking to transfer her franchise, review the franchise agreement carefully to determine the conditions precedent to transfer. The terms often give the franchisor some discretion in deciding whether the proposed transferee will be acceptable. Contact (or have your client contact) the franchisor early in the process to determine the requirements for a new franchisee so that your client does not waste her time negotiating a sale with a buyer who will clearly not be approved. Sometimes, the franchisor will assist a franchisee in locating a quality buyer. Since this is an area where the franchisor has discretion, communicate clearly with the franchisor at all steps in the process to help your client successfully sell her business. Finally, ensure that your client will be relieved from liability to the franchisor after the transfer.

IV. REPRESENTING FRANCHISEES IN A DISPUTE

Franchise disputes, even the simplest ones, have layers of complexity. In representing franchisees, you need to know the key questions to ask, the important documents to review, and the key issues that most franchise disputes present. This section of the paper discusses the basic factors to consider to advise the franchisee of her risks and opportunities, her leverage (or lack of it), and her range of exposure to loss or potential for gain. Your aim should be to cost-effectively give her the information she needs to determine the best strategy to resolve the dispute or litigate the case consistent with her values, financial situation, and business goals.

38Levitas and Hillman, Hot Topics on Transfer and Assignment By Franchisees, at 11 (2005).
39Generally, id.
40See id. at 13; Einhorn & Tractenberg, Renewals and Conditions on Renewal at 4 (2004); Haw. Rev. Stat.. §482E-6; (West 2011; Ark. Code Ann. §4-72-205 (West 2011)
41See, e.g., Iowa Code. §5523H.5 (West 2011); Minn. Stat. §80C.14 (West 2011).
A. The Information You Need

Your first task in analyzing any dispute is to gather the information you need to properly advise your client.

1. What Does Your Client Want to Achieve?

Determine your client’s business goals relative to the dispute. Does she want to keep the franchise, renegotiate its terms, sell it to someone else, or terminate it? If she wants to terminate the agreement, does she expect to seek damages or to minimize what she might have to pay the franchisor? Also, if she wants to terminate, what does she plan to do? Deidentify and run the same business in the same place or territory? Start a similar business outside the territory? Go to work for a similar business? Or do something altogether different?

The answers to these questions will frame your approach to the dispute. As a simple example, for a franchisee in breach who wants to keep the agreement, the right response might be simply to call the franchisor and ask for the right to cure. If you think you will need leverage in the discussion, you may want to do some initial research on potential claims or defenses before making the call.

Or, as another example, assume the franchisee wants to rescind the agreement, compete against the franchisor, and seek damages. This would require you to dig deeply into the facts and law to devise a strategy for either obtaining powerful leverage in negotiations or winning what would likely be a hard-fought litigation.

The cost of your services is often a driving consideration in these initial steps. Franchisees come in many shapes and sizes. Your franchisee client, for example, could be a publicly-traded company that owns hundreds of units. More commonly, however, your client will own one or a few units, and will be financially strapped by the time she gets to you. So a key factor in figuring out how to respond is how to do so economically and efficiently. Keep that in mind when considering all the recommendations in this paper.

2. Documents to Review

You should assemble and review a group of documents quickly. The most important documents are the correspondence or other documents specifically related to the dispute, the franchise agreement, and the FDD.

If there is a key system-wide issue you are looking into, you may want to review past and current FDDs to understand if the franchisor’s representations as to the system-wide issue have changed. If the system-wide issue relates to operations rather than disclosure, you should review the franchise manual. Franchisors often incorporate their manuals into the franchise agreement by requiring franchisees to comply with system standards as evidenced in the manual, which the franchisor reserves the right to amend.

To complement this, review the franchisor’s website, do an Internet search on the franchisor, and review any marketing materials the franchisor gave your client.
Ask your client if she ever signed a release. In franchise relationships, it is common for a franchisor to ask a franchisee to sign a release in exchange for certain benefits or concessions the franchisee has asked from the franchisor.

Finally, ask your client for a timeline of key events.

Now that you have the documents you need, you should start thinking through claims and defenses.

B. Does Your Client Have a Claim or Defense?

Franchisees’ defenses and claims generally stem from four sources: the franchise agreement, the FDD, state statutes, which we review in turn, and the common law, which we discuss throughout the sections.

1. An Initial Consideration: The Potential for Joining Franchisees

In addition to considering your client’s individual defenses and claims in the dispute, you should consider any system wide claims that other franchisees would also share. It may be to your client’s advantage for other franchisees to join in the claim so as share expenses of the suit, and to gain leverage by presenting a united front. On the other hand, negotiating a solution for your client individually may present advantages to pressing the claim on behalf of multiple franchisees.

If other franchisees want to join in the claim, you will need to consider the joint representation rules of Model Rule 1.7 to determine whether you will be able to provide competent and diligent representation to franchisees other than your initial client. If you cannot do so, you would need to decline representation of the other franchisees.

If you do represent multiple franchisees, you will need to review the others’ franchise agreements and FDDs as well since over time the franchisor may have changed its FDD description of the matter at issue. To the extent disclosures or provisions differ from those provided to your initial client, you need to figure out if you can forge a common attack that benefits your initial client.

Another avenue to probe is enlisting the aid of the independent franchisee association, if one exists. Independent franchisee associations have standing to bring only a limited type of claims, but they can assist in a number of supportive ways. They can provide information, help you gather information, and provide a platform for communicating with and organizing other franchisees.

2. The Franchise Agreement

In analyzing your client’s defenses and claims, you need to look not only at the contract provision directly at issue in the dispute, but also at a number of other provisions that may

provide defenses or claims. In this section, we review the most common provisions that may provide a defense or claim for your client.

a. **Encroachment**

Some franchise agreements grant the franchisee the license to operate within a certain territory, which can be designated as exclusive, meaning that no other franchise will be granted in that territory. If the franchisor then grants another franchisee the right to operate in any part of that territory, the franchisee has a claim for encroachment. Claims can also arise if the franchisor allows another franchisee from an adjacent exclusive territory to advertise so as to attract customers from your client’s exclusive territory.

A further area for encroachment can arise from Internet sales. Franchise agreements, especially older ones, may not address sales in cyberspace. If the franchise agreement does not address how the franchisor should handle these types of sales, then your client may have a claim for encroachment if the franchisor is selling direct to customers in your client’s exclusive territory.43

A special area for uniting other franchisees in an encroachment claim arises where the franchisor operates a number of brands, such as in the hotel industry. The franchise agreement may protect your client’s exclusivity from the franchisor’s affiliated brands, or may not address the issue. If either of these is the case, your client may have a claim if the franchisor wants to put another unit in the territory from a different brand the franchisor owns. Other franchisees may be facing the same issue, and may be interested in fighting the claim jointly.

Check Item 12 of the FDD to see if the franchisor’s representations regarding territory accurately describe what the franchise agreement provides. If it does not, your franchisee may have a claim for misrepresentation.

Another area to check is whether your state law, either by statute or common law, (i) requires the franchisor to observe the covenant of good faith or (ii) provides or implies a territorial protection even where the franchise agreement does not provide one.45

Finally, encroachment is a claim that may affect other franchisees in the same way it affects your client. If you have a claim, consider asking your client if she wants to recruit other franchisees to join in her claim, and consider asking the franchisee association for help.

b. **Advertising Fund**

Many franchise agreements require franchisees to pay into a national marketing fund that the franchisor controls. The agreement may place restrictions on the franchisor’s use of the funds. For example, many franchisors use the fund to pay for a staff marketing position or to

---


44Iowa Code §523H.6

cover part of the franchisor’s overhead attributable to marketing. If the franchise agreement does not explicitly allow the franchisor to do so, your client may have a claim against the franchisor.

Check Items 6 and 11 of the FDD to see if the franchisor’s representations regarding advertising accurately describe what the franchise agreement provides. This may provide a claim for misrepresentation.

Finally, the advertising fund is a claim that affects all franchisees. If you have a claim, consider whether your client should recruit other franchisees to join in the claim and asking the franchisee association for help.

c. **Rebates**

Franchisors often negotiate with suppliers to the franchise system to obtain rebates based on volume purchasing by franchisees. Franchisors are not legally required to distribute the rebates to franchisees, or to apply the rebates in franchisee’s favor. If the franchisor does take rebates, but the franchise agreement does not allow for doing so, your client may have a contract claim that the franchisor should have remitted the rebates to the franchisees.

Further, if franchisors do take rebates, they must disclose this in Item 8 of the FDD. If the franchisor has failed to disclose its rebates’ policy, your client may have a claim for fraud or breach of contract.

Undisclosed rebates are a claim that affects all franchisees. If you have a claim, consider whether your client should solicit other franchisees to join in her claim, and consider asking the franchisee association for help.

d. **Sole Supply**

Franchisors are not legally prohibited from requiring franchisees to purchase goods from a sole supply source. If a franchisor does so, however, it must disclose the requirement in Item 8 of the FDD and it must include that restriction in the franchise agreement. If the franchisor requires the franchisee to purchase from a sole supply without having the right to do so in the franchise agreement, the franchisee likely has a claim for breach. Also, if the franchisor requires the franchisee to purchase from a sole supplier but has not disclosed that restriction in its FDD, the franchisee may have a claim for fraud or breach of contract, as well as an antitrust claim under the doctrine of tying.46

Sole supply requirements can be a claim that affects all franchisees. If you have a claim, consider asking your client to recruit other franchisees to join in her claim, and consider asking the franchisee association for help.

---

e. **Failure to Support**

Franchise agreements often promise franchisees support and training in, among other things, marketing, operations, and recruiting employees. The agreement can describe these duties generally or can specify certain types of help, such as the availability of a regional operations representative. Failure to provide this support may be a breach of the agreement.

As a note of caution, though, many franchisees believe that the franchisor has not given them proper support. While that may be true, damages from lack of support are very difficult to prove, and lack of support rarely prevails as a claim or defense.

f. **Quality Control**

Franchise agreements often require franchisees to adhere to quality standards. The agreements usually specify the standards by incorporating the systems manual, which the franchisor can unilaterally amend from time to time. To make sure that all units in the system maintain the standards, franchisors often send out quality control inspectors or secret shoppers/guests to test franchisee units. Based on these inspections, franchisees receive a quality score along with a series of improvement recommendations. Franchise agreements typically provide that if a franchisee fails a certain number of these inspections within a certain period of time, the franchisor can terminate the franchisee.

There is inherent subjectivity in any quality inspection or control report. Thus, these can be challenged directly with the franchisor, or if necessary in court. As with lack of support, though, a note of caution is worthwhile here. Many franchisees with failing quality scores feel that the franchisor or the particular inspector is biased. While that may be true, it can be very difficult and expensive to prove absent a blatant error or change in score.

g. **Fairness Considerations**

Some franchise disputes present basic fairness issues. For example, assume a franchisor is requiring its franchisees to renovate their units, or to buy a new point of sales system. The franchisee may be having economic challenges, and may need time to renovate the unit or buy the POS system. There are times when the franchisee will have some contractual protection to give her time to fulfill the requirement. Often times, though, there is no contractual protection, and the contract gives the franchisor the right to require the franchisee to renovate or to purchase the POS system. Even where there is no contractual protection, the franchisor may be willing to provide your client some leeway if she has been a “good citizen” of the system. And if the franchisor refuses to provide leeway and terminates your client, basic fairness issues may still influence a judge or arbitrator.

3. **Does the Client Have a Disclosure Claim or Defense?**

a. **Disclosure**

Section I(B) above describes the FTC Rule’s requirements for franchisor representations in the FDD. The FTC Act, however, does not give franchisees a private cause of action. Its only remedy is administrative enforcement through injunctions, fines, and penalties.
Fifteen states and the District of Columbia have statutes requiring franchisors to provide franchisees with an FDD. Fourteen states require franchisors to register with the state to sell franchises in the state. All registration and disclosure states provide private causes of action for rescission or damages if a franchisor fails to comply with its registration and disclosure laws. Many of these states provide that the franchisor’s principals may be individually liable as well.

Some states that do not have franchise registration or disclosure laws do have business opportunity laws that, by definition, govern franchise disclosure. Many of these statutes also provide private remedies for rescission and damages. If the franchisor is not registered or your client did not receive proper disclosure, she may have a right to rescind the agreement. Finally, consider advancing the argument that violation of the FTC Rule constitutes a per se tort under the common law.

b. Financial Performance Representations (FPRs)

The FTC Rule strictly delineates what a franchisor may, and may not, do in terms of disclosing financial information regarding the performance of franchisees. Franchisors are basically given two choices. They may either (i) not disclose any financial performance information, or (ii) to disclose it only in writing, in Item 19 of the FDD, and with the information prescribed in the FTC Rule.

Start by checking Item 19. If the franchisor does not make FPRs, ask your client whether any of the franchisors' employees or sales agents made oral representations. If they did, that violates the FTC Rule. Violation of the rule may, in itself, offer franchisees remedies under state franchise or business opportunity laws. Also, if the information is material and misleading it may be grounds for common law fraud or for violation of state statutes proscribing fraud.

---

47 California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Oregon, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin.


50 Id., §5A:44 at 652.

51 See, e.g., Ohio Rev. Code §§1334.01 -1334.15; see generally Garner, supra, note 43, §6:4 at 662-675.

52 Id.


54 See generally Garner, supra, note 43, §9:30 at 344-354.

55 Id., §9:19 at 318-323.

56 See infra Part IV.B(4)(c).
If the franchisor does make Item 19 disclosures, study them carefully to determine whether they comply with the FTC Rule’s disclosure requirements, and whether they are consistent with the other relevant disclosures in Items 5-7. Some discrepancies may be apparent on the face of the document. Others may require discovery. Also, if the franchisor made oral representations in addition to the Item 19 disclosures, those oral representations can independently be grounds for fraud.57

If a franchisor does not make written Item 19 disclosures, but wants the franchisee to have financial information, the proper course is to allow the franchisee to contact other franchisees. If the franchisor does this, the franchisor should not in any way suggest which franchisees to contact. If the franchisor does steer the perspective franchisee to only those franchisees that have been successful, that too is grounds for a fraud claim.

c. Initial Start-Up Costs

Under the FTC Rule, franchisors are required to represent initial start-up costs in Item 7 of the FDD. Check with your franchisee to determine whether her start-up costs were within the range represented. If they were not, she may have a potential claim for misrepresentation. Your first inquiry should be what your client’s actual costs were, and whether they were incurred in the ordinary course using good business practices, or whether they resulted from any unusual circumstance. If your client’s costs were incurred in the ordinary course, using good business practices, you would then need to explore in discovery whether the franchisor misrepresented its average costs as determined by the FTC Rule’s requirements. Even without discovery, the existence of a potential claim can be used for negotiation.

d. Other Misrepresentations

Ask your client whether the franchisor made any misrepresentations other than those related to earnings or initial costs. For example, did the franchisor promise a special location or a powerful marketing campaign backed by significant resources? If so, and the representation was not true, the franchisee may have either a misrepresentation or breach of contract claim.

e. Disclaimers

A warning on fraud claims: When the franchisee signs the franchise agreements, nearly every franchisor requires franchisees to sign a disclaimer that states that the franchisee did not rely on any oral representations about the franchise in making the decision to purchase. Often times, the franchisee is required to sign specifically that she did not receive any oral representations regarding financial performance. Integration clauses can bar a fraud claim based on oral representations.58 Look carefully at the appropriate state law regarding defenses to integration clauses.


4. Statutory Violations

In the prior sections, we have discussed statutory violations as they arise under specific claims or defenses. In this final section, we discuss a few common statutory claims or defenses that we have not discussed above.

a. Improper Termination Under Relationship Laws

Many state relationship laws place the duty on franchisors that they may terminate only in good faith. Good faith usually means that when the franchisor has a right that involves the exercise of discretion, the franchisor must exercise that discretion in good faith.\(^59\)

Good faith does not require a franchisor to be kind, generous, or charitable. Thus, if your client is missing royalty payments because she has been neglecting her business as a result of an aggressive cancer, the franchisor may terminate her so long as the franchise agreement provides that failing to pay royalties when due is an item of default.

Further, with limited exceptions, good faith generally cannot be stretched to create a new duty where no duty already exists in the franchise agreement. Thus, if the franchise agreement does not require notice of default and an opportunity to cure, and the relevant state law does not have a relationship statute that requires it, and the franchisor has not orally informed your client that it had that duty, then the concept of good faith cannot be used to argue that the franchisor had the duty.

b. Equal Protection

Some state relationship laws require that franchisors treat franchisees equally.\(^60\) This provision can provide a defense or claim, but is subject to the defense that the franchisor can treat franchisees differently based on reasonable circumstances. So, for example, a franchisor can give one franchisee concessions on royalties without the need to give it to every franchisee who asks for concessions. The claim is strongest when the franchisor acts arbitrarily and appears to be motivated by malice in singling out one franchisee for different treatment.

c. Little FTC Acts

Many states have statutes patterned after Section 5 of the FTC Act, which prohibit unfair methods of competition and unfair or deceptive acts or trade practices.\(^61\) These Little FTC Acts prohibit conduct that is unfair or deceptive, which are broad proscriptions. These acts also often allow private actions for damages, attorney's fees, and multiple damages. Check carefully,


\(^{60}\) See, e.g., Wash. Rev. Code §19.100.180(2)(c).

though, whether the act extends to franchise disputes as some states limit standing to consumers suing for personal, not commercial, purposes.62

C. Options for Business Resolution

Now that you have gathered the documents and thought through defenses and claims, you need to consider business aspects of the dispute as they affect the franchisor and your franchisee as well as how they affect the franchisor’s broader business goals. The following are some special considerations.

1. System Wide Considerations

In our discussion of claims and defenses, we raised a number of issues that could be system wide claims. If you come across a system wide issue and it is reasonably strong, you may want to suggest to the franchisor to deal with the issue proactively, and to dismiss (or not file) the suit against your client so that the franchisor does not need to deal with the issue through litigation. Or if you start to inquire with other franchisees or otherwise about the system wide claim, your inquiries alone may be enough to prompt the franchisor to buy its peace by settling your suit. Understand, though, that once you make a system wide claim known to others, or you assert one in litigation, you may force an early settlement if the claim is sufficiently strong and clear, or you may be triggering a long, costly, high-stakes litigation.

2. Item 3 Disclosure Sensitivities

Item 3 of the FTC Rule requires franchisors to disclose litigation with franchisees. While there are certain exceptions as to what type of suits the franchisor must disclose, assume that, as a practical matter, the franchisor is required to disclose all litigation with the franchisee (though you should not assume that the franchisor has actually done so).

Item 3 also requires the franchisor to disclose how the suit was resolved. Thus, settlement terms cannot be confidential.

You should think through how the disclosure requirement affects your case strategy. If the dispute comes to you before the franchisor or franchisee has filed suit, the franchisor can settle the dispute without having to disclose the dispute or the settlement terms in Item 3 of the FDD. This is because the disclosure requirement is triggered by the actual filing of a lawsuit or arbitration, and not the existence of a dispute that has not yet ripened into actual litigation. To the extent the franchisor wants to avoid disclosure, this may give you leverage in negotiations for your client.

Once suit is filed, however, the franchisor may have a disincentive to settle on terms that would appear favorable to the franchisee. Disclosing such a settlement in the FDD could encourage similar claims or give the impression that the franchisor is unwilling to stand strong in litigation. Thus you need to think through possible settlement terms that are favorable to your client from a business perspective yet also allow the franchisor to report the terms in the most favorable light possible.

3. **Franchisor's Broader Business Strategy**

Use the Internet and other resources to learn about the franchisor’s current financial condition and business strategy. Is the franchisor looking for a buyer or seeking financing privately or through a public offering? If so, you may have leverage by, on the one hand, offering a quick and quiet resolution to the dispute or, on the other hand, threatening a long and public battle (assuming you have grounds to do so). Franchisors seeking financing or a buyer would rather not have the nuisance of bad press or the distraction of a public lawsuit. Think through whether this is something you can use to help your client.

4. **Equitable Grounds for Cure**

If your client has defaulted, and has no legal defense, but does have a sympathetic explanation for the default, raise the issue with the franchisor and ask for an opportunity to cure. Never forget that no matter how large and impersonal the franchisor organization may be, or whatever reputation it may have for playing hardball, decisions are made by human beings, who can be influenced if approached in the right way. We cannot tell you what your chances will be of persuading any franchisor to allow an equitable cure, but we can tell you that many have done so and you will not know until you ask.

5. **Negotiating Termination**

Franchisees may come to you who are losing money and are unable to sell their franchise to a new franchisee. They may or may not already be in default. Their goal is for you to help negotiate favorable terms for the franchisee to terminate.

   a. **Liquidated Damages/Lost Future Profits**

One of the biggest threats the franchisee will face is liquidated damages or damages for lost future profits. Depending on circumstances, and depending on which state’s law is being applied, courts award franchisors future damages if a franchise agreement is terminated early.

   First, check whether the franchise agreement has a liquidated damages provision. If it does, analyze whether the clause can be challenged under the common law principle that liquidated damages provisions need to be reasonable; otherwise, they are considered a penalty and unenforceable. If there is no liquidated damages provision, then the franchisor may still have a common law claim for future lost profit damages. The theory is that a franchise agreement requires a franchisee to operate a franchise unit for a full term. If the franchisee fails to do so, the franchisor has lost profits, which can be recovered as damages.

---

63 Also, Item 21 of the FDD contains the franchisor’s financial statements for the previous two fiscal years.


Once you understand the situation, you want to persuade the franchisor not to assess any kind of liquidated or future lost profit damages against your client. Part of your argument may be legal based on the applicable state law. The other part may be based on fairness. If your client really is losing money, the franchisor’s argument for future lost profits appears unreasonable as a franchisee losing money cannot stay in business. Also, many franchisors will simply agree to let the franchisee close under these circumstances. This has a practical aspect as well for the franchisor. If your client is losing money, she may be judgment proof. If your client has personally guaranteed the franchise agreement, though, she may be personally collectable even if the business entity is not.

b. **Buy Time/Ease the Pain**

You should explore with your franchisee whether she wants time before termination. She may have commitments she would like to keep, like leasehold or bank obligations, or be expecting a short-term burst of business that would bring in significant revenue. She also may want to try to find someone to buy the unit as a going concern. If she does, you should ask the franchisor if it knows of anyone looking to buy, or whether the franchisor has other franchisees that may be looking to expand. Likewise, she may be working with a prospective buyer, but needs time and the franchisor’s cooperation to close the deal. If the prospective franchisee meets the franchisor’s qualifications, the franchisor has an incentive to work with you since the franchisor would like the unit to stay open with a strong franchisee. Also, the franchisor may seek to preserve the good-will in the unit by not wanting it to go dark.

c. **The Bank**

In many types of terminations, banks become involved because they have loans with the franchisee that are secured by property used in the franchise. If the franchisor wants to take over the unit, which is a right that many franchise agreements provide, it is in everyone’s interest to work with the bank. The franchisor’s goal is to make sure the transition is as seamless and cost-effective as possible. Your job for your client is to use her leverage as the possessor of the property to minimize her losses.

**D. Litigation Options: Analysis and Creating Realistic Expectations**

Once you have analyzed the franchisee’s potential claims and defenses, as well as the opportunities for business resolution, you need to analyze the procedural litigation issues and convey them clearly to the franchisee so that she has realistic expectations about the process and likely outcome. The goal is to provide her with enough information so that she understands the strengths, weaknesses, risks and opportunities of her case, and her leverage (or lack of it). Based on this information, she can decide how to approach the dispute based on her business interests and values.

1. **Cost/Benefit Calculation**

You should make as reasonable an estimate as possible of the likely costs of litigation. This will require analyzing a number of the factors discussed in this paper, such as whether the litigation will be handled in court or arbitration, whether complex legal issues need to be briefed, and determining how aggressive you will need to be to prove your claims and defenses, and how aggressive the franchisor is likely to be in pressing its case.
You should also determine a worst-, most likely-, and best-case outcome for your client. This requires not only analysis of the issues discussed in this paper, but good judgment that comes from experience. Consider running the issue by experienced members of the bar to inform and test your judgment.

2. **The Trademark License under the Lanham Act**

Franchise agreements almost always contain a trademark license, which allows the franchisee to do business using the franchisor’s trademark. Trademarks are governed by the federal Lanham Act, 15 U.S.C. §1125. Once a franchisor terminates a franchise agreement, the franchisee no longer has a license to do business using the franchisor’s trademark. Under the Lanham Act, the franchisor can bring an action for a temporary restraining order or a preliminary injunction to force the franchisee to stop using the trade name and to de-identify the premises to remove all uses of the trade name along with any design attributes strong enough to constitute trade dress.

If a franchisor has properly terminated the franchise agreement (or, in some cases, even if your client has stopped paying royalties), you should assume that the franchisor will be able to promptly attain an order from the court compelling your client to de-identify. Further, the Lanham Act provides that the violating party may be responsible to pay the fees to the trademark holder. Thus, your franchisee could be ordered to pay the franchisor’s attorneys fees for obtaining the de-identification order.

Given the near-certainty of this remedy, you should advise your client to de-identify promptly.

3. **Non-Compete Injunction**

Franchise agreements typically have non-compete provisions that apply during the term of the agreement and that also extend for a set period after termination. If the franchise agreement is terminated, and your client continues to do business, she faces the potential of a temporary restraining order or a preliminary injunction trying to enforce these provisions. De-identification avoids the risk of an injunction under the Lanham Act, but is not a defense to an action to enforce a non-competition covenant.

You first need to determine your client’s business goals. Does she want to work in the same field she was in as a franchisee? Does she want to operate in her current location? If so, your goal is to figure out how to defend against or defeat the non-competition covenant.

Your first step in the analysis is to look carefully at the non-competition covenant. Are there ways that your client can continue to work, or continue to use the building, without violating the covenant? For example, a non-competition covenant for a Mexican restaurant concept may prohibit your client from operating another Mexican restaurant concept, but may not prohibit your client from converting to, say, a Chinese food concept.

If no good options exist based on that analysis, you need to analyze the non-competition covenant itself under the appropriate state law to determine whether it is enforceable or whether
a court might blue pencil the covenant so as to narrow its scope. For example, is the clause vague or too onerous under the applicable state standard?66

The final step in the analysis is to determine whether you have any general legal defenses to the termination or to the enforcement of the non-compete. For example, are there grounds for rescission based on fraudulent inducement or disclosure violations? Rescission would mean that the non-competition covenant is rescinded along with the rest of the agreement. If you have a reasonably plausible claim or defense, you stand a fair chance of prevailing against a preliminary injunction to stop your client from competing so long as your client has de-identified. Courts are quick to enforce de-identification orders because of the strong public policy against confusing consumers. They are much more reluctant, though, to enter a preliminary injunction that puts a franchisee out of business when she has a good faith defense she wants to develop and present.

4. **Franchisor’s Right to Buy Business**

Many franchise agreements give the franchisor the right to buy the franchisee’s business or assets upon termination. Franchisors may seek to acquire the business as a corporate unit or to run it short-term while seeking out a new franchisee. This is a powerful remedy, and the terms of purchase are almost always favorable to the franchisor.

If the franchisor has the right to purchase your client’s business or assets, you must fight the termination. If you have a reasonably plausible defense to termination, you stand a fair chance of prevailing against a preliminary injunction forcing your client to turn over her business. Judges are reluctant to enter a preliminary injunction taking away someone’s business when she has a good faith defense she wants to develop and present.

5. **Mediation**

Some franchise agreements require parties to mediate before either may file suit. The agreement generally requires the mediation to be conducted in the city of the franchisor’s principal place of business.

If the franchise agreement does require mediation before filing suit, either party that files suit without first mediating risks having the suit dismissed or stayed pending mediation.67 If the agreement requires mediation first, and the franchisor files its lawsuit before mediation, think through whether you want to seek to dismiss or stay the franchisor’s suit. If you don’t think mediation will be fruitful, you may be incurring unnecessary fees briefing the issue and then participating in a fruitless mediation. On the other hand, filing the motion can buy time and can force the franchisor to sit down to talk. Many mediation clauses require good faith. The requirement imposes a duty of good faith on both parties, but the duty is somewhat illusory as courts are reluctant to provide a remedy to a party who believes the other side did not mediate in good faith.68

---

66See generally Covenants Against Competition in Franchise Agreements (Peter J. Klarfeld ed.) (2d Ed. 2003), and Garner, supra, note 43, §§8:49 – 8:59 at 162-197.

67See, e.g., DeValk Lincoln Mercury, Inc. v. Ford Motor Co., 811 F.2d 326, 335-36 (7th Cir. 1987).

Some in the franchisee community believe that mandatory mediation clauses are punitive. According to this view, franchisors require mandatory mediation primarily to force franchisees to jump through expensive, time-consuming hoops and give the franchisor notice before filing suit. You may find cases where this is so. Because franchisors generally require franchisees to mediate in the franchisor’s home city, franchisees bear the time and cost of travel. Also, you can spend a good deal of time preparing for mediation, only to show up and find the franchisor is not proceeding in good faith.

It is often best to proceed on the assumption that, unless you know otherwise, that the franchisor will proceed in good faith. Mediation is a very powerful tool in resolving suits. Thus, you should prepare seriously and strategically. Even if the mediation does not resolve the suit, your preparation is the same preparation you would have needed to do to prepare the case for litigation.

Further, be proactive in managing the mediation. Mediation can be flexible: You can call the franchisor’s counsel to try to craft alternative methods that may speed up or lower the cost of the process. For example, you could suggest that the mediator begin exploring settlement immediately through telephone conversations with the parties to gauge whether a full-day session in person would be fruitful. You could suggest that the entire mediation be conducted by telephone. If cost is a significant issue, you could ask the franchisor if it would come to the franchisee’s home city for mediation, or if the franchisor would bear part of the franchisee’s extra costs incurred for travel and lodging. A franchisor proceeding in good faith should be willing to discuss these issues openly as it, too, is concerned with making the process fruitful and avoiding unnecessary cost and time.

Mediation can also be helpful in many ways short of resolving an entire dispute. If done right, you will likely learn many facts that would not have come out until discovery. You may also be able to narrow the issues to be disputed in the litigation, and to discover where you do and do not have leverage.

Based on what you learn, you may be able to propose a faster, cheaper, and fairer way to resolve the dispute rather than the traditional lawsuit. For example, you could reach agreement to limit the number and hours of depositions, to eliminate interrogatories and to limit the scope of document requests. You might agree that after a certain limited amount of discovery, the parties return to mediation to see if they can resolve the suit based on the new knowledge. Or if one legal issue splits the parties, you may try to devise a bifurcated proceeding where the material issue would be decided early by the judge or arbitrator. If the case is set to be tried in a court, you may want to structure an arbitration that would allow for a quicker (and hopefully cheaper) resolution than would be attained in court.

Conversely, many franchise agreements do not have a mandatory mediation clause. If your agreement does not, consider whether to seek early voluntary mediation or to respond positively if the franchisor suggests it. As mentioned above, mediation is a very powerful tool for resolving disputes when both parties proceed in good faith. If you believe the franchisor and its counsel have high integrity, and you can see a range of plausible outcomes that both sides might agree to, early voluntary mediation can be helpful. Even if it does not resolve the suit, it

---

69 See Pete Silverman, Mediation Creates Winners on Both Sides -- Comments, Blue MauMau, http://www.bluemaumau.org/node/7397/talk,
can have the beneficial consequence of narrowing issues or reaching agreement on a streamlined dispute resolution procedure.

In considering early voluntary mediation, consider timing issues. Would mediation succeed better after limited exchanges of information or depositions? Does either party’s personality require some battle before discussing peace? If so, consider structuring limited discovery with the mediation to follow.

6. Arbitration

Many franchise agreements have mandatory arbitration clauses. If they do, the first question you should consider is whether to try to defeat the clause so as to get into court.

On the franchisee side, many lawyers and franchisee advocates believe that mandatory arbitration is harmful to franchisees. A number of advocates have pressed for federal legislation to bar mandatory arbitration in franchise agreements.70

A contrary view exists, though, that mandatory arbitration is beneficial to franchisees.71 Its advantages are that, if done well, it should allow you to try your case quicker and at less cost than in court. Further, if you are careful and thorough, you can select an excellent, neutral arbitrator.

As to whether it is worthwhile to try to defeat the clause, you need to consider a number of factors. First, only a few states have case law that provides any likelihood of prevailing.72 Second, no matter how favorable the state’s law is, the briefing will likely be very expensive. Third, you need to determine and value the advantages you would get from being in court. If there is a legal issue at stake that the franchisor may not want to risk an adverse judgment on, you may obtain leverage by being in court, where collateral estoppel applies to legal rulings.73 Also, will your case turn on the amount of discovery you are allowed to take? Court rules are more liberal on discovery than are arbitration rules, though arbitrators can be persuaded to grant widespread discovery. Another question is where the court proceeding would be. Will you end up before a judge in the franchisor’s home town, or might you be able to obtain venue in the franchisee’s hometown, where you have the chance for a sympathetic judge? Consider whether you would be entitled to request a jury. Many believe that juries are more sympathetic to franchisees than are judges or arbitrators.

70In 2009, Congress attempted to bar mandatory arbitration clauses in certain agreements, including franchise agreements. See Arbitration Fairness Act of 2009 H.R. 1020, S.931, 111th Cong. (2009). The bill remained in committee, but was recently reintroduced. See Arbitration Fairness Act of 2011, H.R. 1873, S. 987, 112th Congress (2011). The current proposed act would not apply to franchise agreements, and would apply only to civil rights, consumer, and employment disputes.


73Arbitrators may have discretion to apply offensive non-mutual collateral estoppel. See, e.g., Collins v. D R Horton, Inc. 505 F.3d 874, 882 (9th Cir. 2007).
If you do proceed with arbitration, you do have a number of factors to consider. The first is whether you want to negotiate the arbitration procedure with the franchisor.

One point to consider negotiating is the element of administration by an arbitration-providing entity. One advantage to the non-administered arbitration is that you would save the administration fees of the arbitration-providing entity. You could also then seek to find a mutually agreeable arbitrator, as opposed to being limited to the administrator’s roster of eligible arbitrators. On the other hand, administered arbitration has advantages. A clear process exists for selecting an arbitrator. If you understand the rules and the system, you will likely be able to select an excellent, neutral arbitrator – perhaps the key element in an arbitration. Further, administrators help ensure procedural regularity concerning issues such as fees and scheduling.

Another possible point for negotiation is the number of arbitrators. If the arbitration clause provides for three arbitrators, you may want to ask the franchisor to agree to one arbitrator, which would save two-thirds of the cost for arbitrator fees. On the other hand, if the clause provides for only one arbitrator, and the case involves large sums of money, you may want to ask the franchisor to agree to a three-member panel. Some believe that a three-member panel is more likely to avoid a random or biased decision.

7. Choice of Venue

Almost all franchise agreements also have an exclusive choice of venue clause, which provides that suit may be brought only in courts in the city where the franchisor’s principal place of business is located. The agreement may actually name that city or it may be a floating clause, which provides that suit will be brought wherever the franchisor’s principal place of business is at that time. Unless your franchisee is in a relationship state where the statute finds venue clauses outside the state to be presumptively invalid, the courts routinely enforce choice of venue clauses. You should study the clause, though, to determine whether it is exclusive. If the franchisor did not draft the statement carefully, it may mean that the franchisee has consented that suit may be brought in the stated venue, but not that that the franchisee is restricted from bringing it elsewhere.

8. Choice of Law

Almost all franchise agreements have a choice of law clause. Unless your franchisee is located in a state with a relationship statute that require that state’s law to apply, a choice of law

---

74In addition to paying for one arbitrator rather than three, you are also not paying for the time for three arbitrators to confer and to comment on written drafts of decisions. Further, with three arbitrators, the case tends to be dragged out longer because of the difficulty in scheduling to accommodate all the arbitrators’ schedules.


77See generally, Garner, supra n. 43, §17:20 at 157 (distinguishing between permissive and mandatory clauses).

78E.g., Cal. Corp. Code §31512, MCL §445.1527, Wash. Rev. Code §19.100.10; for a general discussion of these statutes and their application, see generally, Garner, supra n. 43, §17:24 at 178-187.
law clause will likely govern the law that applies. Choice of law questions can be very complicated, and different results may occur depending on the state in which the suit is filed. If your client will benefit from one state’s law, you should research this issue promptly and thoroughly.

9. Contractually-Shortened Limitations Periods

Franchise agreements often have shortened limitation periods, and they are generally enforceable unless proscribed by state statute or found unreasonable. Check these carefully along with the statute of limitations of the applicable state law.

10. Attorneys’ Fees

Franchise agreements often have attorneys’ fees provisions. These sometimes provide that the franchisor is entitled to its attorneys’ fees if it prevails in a dispute. Other times, the provision is mutual, providing that the prevailing party is entitled to attorneys’ fees, regardless of whether it is the franchisor or franchisee. Courts routinely enforce these provisions, though they are subject to constraints such as reasonableness of the fees, determining whether a party prevailed, and other issues. Also, some states provide that if an agreement has an attorneys' fees provision, it must be reciprocal.

If the clause provides that only the franchisor is entitled to fees if it prevails, then your client bears the entire risk for paying fees, which is a serious disincentive to litigation. If the clause provides that the prevailing party, whether franchisor or franchisee, is entitled to fees, the clause presents risk to both sides and encourages settlement.

CONCLUSION

We have presented an overview of issues to consider in representing franchisees in negotiating franchise agreements, renewals and transfers, and in representing franchisees in disputes with their franchisor. We have tried to give you more than the legal issues, and to reach into the business and practical issues that a franchisee lawyer needs to consider. While the issues regularly evolve and new issues arise, we hope that our presentation will provide a good source for helping you respond when your client calls in a crunch -- I need to negotiate concessions in the franchise agreement and sign it in three days, or I’ll lose my chosen territory. Or in a crisis -- I just got a termination letter.

---

79 Id., §17:23 at 174-178.
82 See, e.g., Burda v. Wendy’s Intern., Inc. 659 F.Supp.2d 928, 938-940 (S.D. Ohio 2009)
83 See generally, Fox & Schaeffer, supra, n.60, at 19001-20.
84 E.g., Cal. Civ. Code §1717 (a).
CHECKLIST

Checklist When Buying a Franchise:

1. Do not fall in love with the deal
2. Review FDD
3. Review franchise agreement
4. Review additional agreements
5. Talk to former franchisees
6. Talk to current franchisees
7. Visit franchised locations
8. Review financial statements of the franchisor with an accountant
9. Have an attorney review Item 3 and Item 4 information
10. Shop Item 7 items to see if investment costs are accurate
11. Review other FDDs
12. Spend Time in locations of competitive businesses
13. Consider negotiating the franchise agreement.

Checklist for Renewal

1. Review franchise agreement for renewal rights
2. Review franchise agreement for conditions
3. Comply with all notice requirements
4. Review new franchise agreement
5. Consider negotiating the franchise agreement

Checklist for Transfer

1. Seek to transfer before franchise expires
2. Review franchise agreement for conditions
3. Comply with notice requirements
4. Obtain new franchisee requirements from franchisor
5. Ensure release from liability.

Checklist for a Dispute

1. Assess client’s goals
2. Gather facts
3. Gather and review key documents – FDD, agreements, releases, timeline
4. Consider whether to join other franchisees
5. Conduct legal and factual research to determine contractual, statutory, or tort claims and defenses:
   (a) Contract claims and defenses may arise from, among other areas: encroachment, advertising fund misuse, rebates, sole supply, failure to support, quality control, and fairness;
   (b) Statutory claims and defenses may arise from, among other areas: improper disclosure, financial performance representations, initial start-up costs, improper termination or equal protection under relationship laws, and Little FTC Acts.
6. Possible Business Resolution
   (a) Systemwide considerations
   (b) Item 3 disclosure sensitivities
   (c) Franchisor’s business strategy
   (d) Equitable grounds for cure
7. Negotiating termination
   (a) Liquidated damages/lost future profits
   (b) Buy time
   (c) The bank
8. Consider whether to challenge dispute procedure
   (a) Mediation
   (b) Arbitration
   (c) Choice of venue
   (d) Choice of law
(e) Contractually shortened limitations periods

(f) Attorneys’ fees
Biographies

Julianne Lusthaus

Julianne Lusthaus is a member of Einbinder & Dunn, LLP and has been practicing law since 1996. Julie represents franchise and other business clients in transactions and dispute resolution. She counsels franchisee clients including franchisee associations in connection with the acquisition of franchises, the negotiation of franchise agreements, including renewal agreements and negotiations concerning disputes with franchisors. Julie also assists start-up franchisors in determining whether franchising is the proper method to further develop their business, creating a franchise program, drafting disclosure documents and other franchise-related agreements and preparing/filing disclosure documents for state registration where necessary. Julie is an active member of the American Bar Association Forum on Franchising; the New York State Bar Association Committee on Franchise, Distribution and Licensing Law; the International Franchise Association; the American Bar Association Law Practice Management Section; the Westchester Women’s Bar Association; and the Brooklyn Women’s Bar Association. Julie has spoken at legal and industry events on franchising and has authored papers on franchising issues.
Peter R. Silverman

Mr. Silverman is a trial lawyer, arbitrator and mediator, and has been recognized by Best Lawyers, Super Lawyers, and Franchise Times Legal Eagles for his excellence in ADR and franchising. He has served as a mediator and arbitrator for over 20 years. In his franchise practice, he represents franchisors, franchisees, and franchisee associations in lawsuits, arbitration, and mediation across the country. He is admitted to practice in Ohio, Michigan, and New York.

Mr. Silverman is a member of the AAA’s national roster of neutrals, complex panel, and serves on the Northern District of Ohio’s Panel of Neutrals. He lectures frequently on ADR and franchise subjects, and is the author of The Client’s Guide to Mediation and Arbitration: The Strategy for Winning (American Bar Association 2008), which is one of the ABA’s best-selling books. He is chair of the Litigation and Alternative Dispute Resolution Committee of the ABA Forum on Franchising, and is a member of the IFA/CPR Franchise Mediation Program Steering Committee.

Mr. Silverman is a partner in the Toledo, Ohio office of Shumaker, Loop & Kendrick. He received his law degree from the University of Michigan in 1981.