BEST PRACTICES IN THE USE OF SYSTEM ADVERTISING AND MARKETING FUNDS

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# TABLE OF CONTENTS

I. INTRODUCTION .................................................................................................................. 1

II. FORM OR ORGANIZATION ................................................................................................. 2
    A. Commingled or Restricted Funds .................................................................................. 3
    B. Unincorporated Entities and Committees .................................................................... 3
    C. Corporations .................................................................................................................. 4
    D. Trusts ............................................................................................................................ 5
    E. Tax Treatment of Advertising Funds ............................................................................ 5

III. DISCLOSURE REQUIREMENTS ......................................................................................... 9
    A. Item 5 – Initial Fees ..................................................................................................... 9
    B. Item 6 – Other Fees ..................................................................................................... 9
    C. Item 7 – Your Estimated Initial Investment ................................................................ 10
    D. Item 8 – Restrictions on Sources of Products and Services ...................................... 10
    E. Item 9 – Franchisee’s Obligations .............................................................................. 11
    F. Item 11 – Franchisor’s Assistance, Advertising, Computer Systems and Training ....... 11
        1. Franchisor’s Obligation to Conduct Advertising .................................................. 12
        2. Franchisee’s Own Advertising Material ............................................................... 12
        3. Advertising Councils ............................................................................................. 12
        4. Local or Regional Advertising Cooperatives ....................................................... 13
        5. Other Advertising Funds ...................................................................................... 13
        6. Use of Unspent Advertising Funds ....................................................................... 14
        7. Franchise Sales .................................................................................................... 14
    G. Item 22 – Contracts ..................................................................................................... 15
B. Forced Participation in Advertising Campaigns........................................41
C. Sources of Supply .................................................................................42
D. Use of Advertising Funds .....................................................................42
E. Anti-Discrimination ..............................................................................42

VIII. DRAFTING CONSIDERATIONS .............................................................44
A. The Franchisor Perspective .................................................................44
   1. Keep Separate Accounting ..................................................................44
   2. Involve Franchisees ............................................................................44
   3. Disclaim Fiduciary Duties ...................................................................45
   4. Disclose Administrative Expenses .......................................................45
B. The Franchisee Perspective .................................................................45
   1. National Advertising Fund Trigger ......................................................45
   2. Spending Caps ..................................................................................46
   3. Segregation of Funds .........................................................................46
   4. Franchisee Participation ......................................................................46
   5. Transparency ....................................................................................47
   6. Limits on Discretion ..........................................................................48

IX. CONCLUSION ..........................................................................................48
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I. INTRODUCTION

The central elements in any franchise system are the brand name and logo associated with the goods, services or products of the franchised business. Indeed, the definition of a franchise in the Disclosure Requirements And Prohibitions Concerning Franchising (the "FTC Franchise Rule") begins with the following component:

The franchisee will obtain the right to operate a business that is identified or associated with the franchisor's trademark, or to offer, sell or distribute goods, services or commodities that are identified or associated with the franchisor's trademark.¹

This portion of the FTC Franchise Rule has remained unchanged since the inception of the rule on January 1, 1979. The various states that have franchise disclosure or registration provisions similarly define a franchise as including the use of the trademark of the franchisor.² Indeed, a number of decisions over the past decades have found that the trademark is such a central and crucial element of any franchise system that if the trademark is lost or abandoned by the franchisor, the franchisee may have grounds to rescind the franchise contract.³

One of the prime advantages of franchising is the ability to leverage the collective purchasing power of the franchisees through the use of pooled advertising funds, cooperatives and similar vehicles to promote the brand for the benefit of franchisor and franchisee alike. As franchising has grown, so have the opportunities to promote brand awareness through such methods. For example, Domino’s Pizza, Inc., a publicly held franchisor, reported in its most recent Securities and Exchange Commission ("SEC") Form 10-K Annual Report for the period ending January 2, 2011, that over the past five years, its franchisees have collectively invested $1.4 billion in the promotion of the Domino’s Pizza brand through various collective advertising activities.⁴ It is worth noting that that investment exceeded the market capitalization of the company on the effective date of the Annual Report.⁵

¹ 16 C.F.R. § 436.1(h)(1).

² For example, the California Franchise Investment Law includes the following element in the definition of a franchise: "...the operation of the franchisee's business pursuant to such plan or system is substantially associated with the franchisor's trademark, service mark, trade name, logotype, advertising or other commercial symbol designating the franchisor or its affiliate..." CAL. CORP. CODE § 31005(a)(2). Similarly, the New York franchise registration law includes the following element in the definition of a franchise: "A franchisee is granted the right to engage in the business of offering, selling, or distributing goods or services substantially associated with the franchisor's trademark, service mark, trade name, logotype, advertising, or other commercial symbol designating the franchisor or its affiliate..." N.Y. GEN. BUS. LAW § 681(3)(b).

³ See, e.g., A to Z Rental, Inc. v. Wilson, 413 F.2d 899 (10th Cir. 1969) (loss of a franchisor's exclusive right to use a trademark or trade name, together with other breaches of the agreement, constituted a material breach of a franchise agreement). See also State Transmissions v. Patrick Cooney, et al., Civil Action No. 89-4865 (E.D. Mich. Jan. 11, 1990); In Re Convenient Food Mart, Inc., et al. v. CF Marts of Cal., et al., 1990 WL 51228 (N.D. Ill. 1990).


Indeed, based on information published by the International Franchise Association and FRANdata, we estimate that franchise systems in the U.S. spend more than $12 billion per year on marketing and advertising.\(^6\)

Not surprisingly, franchisees regard advertising and marketing as the lifeblood of the system. According to author Greg Nathan, “When asked to name the most important aspects of their franchise system, most franchisees mention the brand and services related to marketing.”\(^7\)

Franchisee funded advertising funds have been used to create some of the most famous and successful advertising campaigns ever devised. Everyone has their own favorites, but ours include “Where’s The Beef?” (Wendy’s), “Time to Make the Donuts” (Dunkin Brands), “I’m Lovin It” (McDonalds) and Jared Fogle (Subway).

With these successes and opportunities come issues, questions, challenges and pitfalls.

- Should a start-up franchisor implement a national advertising fund and, if so, when?
- Should the advertising fund be segregated from or commingled with the franchisor’s revenues?
- Should the franchisor establish a separate corporation, trust or other vehicle to receive advertising contributions and expend them?
- To what extent should the franchisor involve its franchisees in the decisions about how to expend the funds they contribute to the pooled advertising vehicle?
- What disclosure obligations does the franchisor have with respect to the contributions franchisees must make to national or local advertising funds or cooperatives?
- What limits are there on contractually reserved discretion on the part of franchisors to make decisions regarding the expenditure of advertising funds?
- What steps can a prospective franchisee take to negotiate provisions in the franchise agreement that will enhance its protection regarding advertising funds?
- How does a franchisor lessen the likelihood of conflict or litigation in its system over pooled advertising funds?

This paper will address these and other issues.

II. FORM OF ORGANIZATION

Once a franchisor determines that it will charge a separate fee for a national advertising fund, it has a number of decisions to make concerning how the advertising fund will be organized. There are no federal or state statutes or regulations which govern or restrict how a


\(^7\) Greg Nathan, How to Create Healthier Franchise Relationships and Happier Clients, 13(1) THE FRANCHISE LAWYER 11 (Winter 2010).
franchisor may structure its national advertising fund. While there are certain disclosure requirements concerning advertising payments, funds and cooperatives, particularly those found in Item 11 of the FTC Franchise Rule, there are no substantive regulations concerning the structure of such a fund. Generally speaking, the tax consequences of the choice are minimal, as is demonstrated in section II.E, infra.

Having the fund segregated in some fashion, whether simply as a restricted asset on the books and records of the franchisor, in a separate bank account or held by a separate entity such as a non-profit non-stock corporation or a trust has many advantages for both franchisor and franchisee.

A. Commingled or Restricted Funds

Some franchisors simply account for advertising fund contributions and expenditures separately from their profit and loss statement, but not the balance sheet. For example, in the Choice Hotels, Inc. financial statements contained within the company’s most recently filed SEC Form 10-Q, marketing and reservation revenues derived from franchisees are excluded from the company’s revenue as it is “contractually required by its franchise agreements to use these fees collected for marketing and reservation activities; as such no income or loss to the company is generated.” Any marketing and reservations fees that remain unexpended as of the end of the fiscal year are recorded as a liability on the company’s balance sheet; correspondingly, any excess of expenditures over contributions is treated as an asset of the company on its balance sheet. Other franchisors simply include both the revenue and the expenses on their own profit and loss statements. In either case, the contributions are not held in a separate fund or vehicle, thus making franchisee-generated funds subject to the claims of general creditors of the franchisor, as well as being pledged to secured lenders of the franchisor. In addition, there are no governing documents separate from the terms of the franchise agreements that limit the discretion typically reserved to the franchisor.

B. Unincorporated Entities and Committees

A number of franchisors have formed committees or other entities to provide advice, guidance and input to the formulation of advertising plans and campaigns. These committees are often not incorporated and thus do not provide any insulation from personal liability. Seldom do these committees have any veto power over the franchisor’s use of pooled advertising funds.

In Advertising and Policy Committee of the Avis Rent-a-Car System v. Avis Rent-a-Car System, a Texas Appellate Court affirmed a trial court’s directed verdict in favor of Avis, finding that Avis was not bound by the decisions of the licensee-controlled advertising and policy committee, notwithstanding the fact that the license agreement vested that committee with decision-making powers over the advertising fund. The linchpin of the court’s decision appears to be the franchisor’s exclusive rights to the system and its trade name and its contractual right to disapprove any advertising in which its name may be used.

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9 Id.

C. Corporations

Domino’s Pizza Inc. has created a non-profit subsidiary corporation, apparently wholly owned or controlled by the franchisor, which receives all of the advertising contributions made by franchisees and the franchisor’s company-owned stores and expends those funds in accordance with the governing documents.\textsuperscript{11} This arrangement gives the franchisor no liability for the debts and obligations of the non-profit subsidiary and grants no explicit governance rights to the franchisees who provide the revenue. However, given that the subsidiary is not for profit, but not tax exempt, it cannot ignore the tax issues that apply to all such funds.

Establishing a separate non-profit or non-stock corporation has a number of advantages for the franchisor and the franchisee. The directors may have fiduciary and other duties imposed by state laws and the assets of the entity may not be reached by the creditors of either the franchisor or the franchisee. The governing documents will reflect an attempt to create a fair and workable balance of power between the franchisor and the franchisee. Inevitably, conflict develops over time.

The KFC national council and advertising cooperative (NCAC) is a non-stock corporation founded more than forty years ago and is charged with both the generation of advertising plans for the KFC brand and the approval of specific KFC advertisements. The NCAC is governed by a committee which consists of thirteen franchisee representatives and four KFC representatives. The NCAC is funded by a mandatory contribution of 3% of total sales from every KFC store in the United States, including company-owned stores. That assessment yields an annual budget of approximately $150 million.

This structure was a subject of a widely reported decision of the Delaware Court of Chancery in January of this year. In \textit{KFC National Council and Advertising Cooperative Inc. v. KFC Corp.},\textsuperscript{12} the court held that the NCAC had the authority to adopt advertising programs and to change or amend the franchisor’s proposals as approved by a majority of the committee. The court cautioned that the franchisees have a strong incentive to be “good shepherds of the KFC brand”\textsuperscript{13} and that the NCAC was obligated to use KFC’s marks “in good taste and consistent with the current Bylaws of the NCAC.”\textsuperscript{14}


\textsuperscript{13} Id. at 19.

\textsuperscript{14} Id. at 20.
D. Trusts

Franchisors may be reluctant to use a trust entity, as the fiduciary duties they impose are more stringent and explicit than those involving self-dealing in the corporate context. A trust must be administered for the benefit of the beneficiaries, in this case the franchisees, whose funds it receives and spends for their benefit. Using an independent trustee does not solve, but only adds to, the franchisor's dilemma.

An advertising trust fund in the Subway system has generated significant controversy and litigation, as described in great detail in sections V.B and V.E of this paper. The Subway Franchise Advertising Fund Trust is a trust created in 1990 by Doctor's Associates Inc., the franchisor of Subway, for the purpose of funding group advertising and promoting of Subway shops. The trust was managed by a board of directors comprised of Subway franchisees elected by the franchisees.

The Delaware Court of Chancery in the KFC case did not see KFC's sole right to its trademarks as a barrier to the implementation of agreements that gave a trust broad discretionary power over approval of advertising. Rather, it saw KFC's use and ownership of the marks as a factor and limiting condition on the trust power to approve advertising plans.\(^{15}\)

With KFC and Subway, mature franchise systems involving substantial numbers of franchisees, each having a separate trust arrangement, one would naturally assume that this would lead to less conflict. In fact, each of these systems has been involved in extensive litigation over the terms and conditions of these separate arrangements. This only underscores the tension between the franchisor's goal of controlling the manner in which its marks are used and promoted, and the franchisees' interests in having a meaningful role in deciding how the funds they contribute are spent.

E. Tax Treatment of Advertising Funds

For more than 60 years the Internal Revenue Service (the "IRS") has conducted an extended dispute with the Tax Court and various District Courts over whether the receipt of pooled advertising funds creates taxable income to the franchisor.

This long running battle began with The Seven-Up Company v. Commissioner.\(^{16}\) In the Seven-Up case, franchise bottling distributors each had an exclusive territory, but there were no preexisting arrangements for pooled advertising programs. Each franchisee was responsible for advertising and marketing in its exclusive territory with direction and input from the franchisor. A proposal was developed in conjunction with an advertising agency to create a national pooled advertising fund on a voluntary basis. Franchisees initially agreed to pay $17.50 per gallon of 7up extract to such a fund with contributions commencing May 15, 1943. Franchisees that declined to participate in the program were permitted to continue to operate their franchise businesses without interference or consequence. Because the franchised bottlers had no central organization or association of their own, it was proposed that the payment would be made directly to the franchisor with an explicit assurance that its advertising receipts and expenditures would be open to the inspection of any franchisee at any time. The franchisor did

\(^{15}\) Id. at 19-20.

\(^{16}\) 14 T.C. 965 (1950).
not establish a separate bank account for the advertising funds, but the funds were segregated and earmarked on its books.

For the tax years in question, the franchisor neither included the advertising contributions made by franchisees as gross income on its books, nor did it seek or take a deduction for its expenditures from the funds furnished by franchisees. Unexpended amounts at the end of each year were included in "accounts payable" on the balance sheet of the franchisor. The Tax Court found that the funds contributed by the bottlers constituted a trust fund for advertising purposes which it had administered as agent for the franchisees. Yet, the fact that the funds were commingled with the franchisor's general revenue did not destroy this trust arrangement.

The Tax Court summarized its holding as follows:

As custodian of the funds and agent for the bottlers, petitioner was obligated to expend them for national advertising and any diversion for corporate and other purposes might be enjoined by the bottlers by a suit in equity.

petitioner did not receive the bottler's contributions as its own property. They were burdened with the obligation to use them for national advertising. No gain or profit was realized on the receipt because of this offsetting obligation.

The court seemed to emphasize the fact that the books and records of the franchisor with respect to the receipt and expenditures from the advertising funds were open to the franchisees at all times and that the franchisees had significant input in the determination of how their funds were spent.\(^\text{17}\)

The IRS acquiesced in this result.\(^\text{18}\)

The next year, the court decided Broadcast Measurement Bureau, Inc. v. Commissioner,\(^\text{19}\) which involved a non-profit corporation whose mission was to conduct national surveys to measure radio audiences for the benefit of its members. The Tax Court held that Broadcast Measurement Bureau was not required to include in its income the amounts contributed by members for the study. In so holding, the court found that there was a trust based on the intent of the parties as expressed in the subscription agreement, as well as their conduct in carrying out that agreement.

After a hiatus of some sixteen years, the IRS then litigated the same question again in three separate cases, in all of which the IRS did not prevail.

Angelus Funeral Home v. Commissioner\(^\text{20}\) involved contracts for pre-paid funeral plans which specified that amounts paid were trust funds and restricted as to use. The Tax Court held that the payments received by the taxpayer were not includable in its income, notwithstanding

\(^{17}\) Id. at 978.


\(^{19}\) 16 T.C. 988 (1951).

the fact that it commingled the funds contributed under these trust arrangements with its general funds.

In Dri-Power Distributors Association Trust v. Commissioner,\textsuperscript{21} the court found that a trust existed under California law inferred from the course of conduct and other circumstances between the parties. While the independent distributors referred to their manufacturer as a trustee, the court found that the distributors themselves actually made all of the decisions regarding the funds. There was no formal declaration of trust nor was there any appointment or acceptance of trust duty by any trustee. However, the manufacturer did establish a separate bank account for the advertising contributions. For all of these reasons, the Tax Court held that the advertising contributions were not taxable to the manufacturer.

The third case was Ford Dealers Advertising Funding v. Commissioner.\textsuperscript{22} In Ford, the IRS position was once again rejected by the Tax Court and the resulting holding was affirmed on appeal. Ford involved a non-profit corporation restricted to dealers in the Jacksonville, Florida area which received contributions from both the dealers and the manufacturer. Those who agreed to participate in the program authorized their required advertising fund contributions to be added to the invoices that the manufacturer issued for the cars and trucks they purchased. The payments were made directly to the manufacturer but administered by the non-profit corporation. The Tax Court found that "as to all funds received a trust was created by virtue of the contractual agreements, the by-laws in charter, the operations of advertising itself and the intentions of all parties concerned."\textsuperscript{23}

Despite this string of defeats, the IRS was adamant in its refusal to accept these determinations. Apparently, the IRS was concerned by the rapid growth in franchising and the potential proliferation of pooled advertising funds. In addition, the IRS believed that since pooled advertising funds are not tax exempt entities, they should not be immune from taxation.

In 1974, the IRS issued two consecutive revenue rulings, the effect of which was to ignore the rulings in Seven-Up and Broadcast Measurement. To that end, the IRS changed its acquiescence in Broadcast Measurement to nonacquiescence.\textsuperscript{24}

Revenue Ruling 74-318 provides that where an advertising association has discretionary control over the use of the advertising fees paid by the member dealerships and the manufacturer, the amounts paid are includable in gross income with ordinary deductions allowable.\textsuperscript{25} This Revenue Ruling flies in the face of the holding in Ford.

Similarly, Revenue Ruling 74-319 provides that an advertising fund established by franchisee dealers administered under written contract by the manufacturer who receives and bills non-refundable fees, spends the accumulated funds on national advertising only for the


\textsuperscript{23} Id. at 772.

\textsuperscript{24} 1974-2 C.B. 4.

\textsuperscript{25} Revenue Ruling 74-318, 1974-2 C.B. 14.
dealers' benefit, accounts for the fund separately in the books, and carries year-end balances as a liability to the dealers, is an association taxable as a corporation.26

After the issuance of the revenue rulings in 1974, the IRS continued to litigate this issue with no more success than it achieved in the past.


Insty-Prints had begun franchising in 1966. In 1969, it began to require franchisees to make contributions to a national advertising fund. While the funds were actually paid to Insty-Prints, it created a separate ledger account on its corporate books and segregated the advertising funds in a separate bank account.

In 1973, a trust agreement established the Insty-Prints National Advertising Fund which was entered into by Insty-Prints as a grantor and Frank and Frieda Schochet as trustees. The beneficiaries of the trust were the Insty-Prints franchisees as well as the company-owned stores. The IRS unsuccessfully argued that the trust fund was taxable and therefore was required to include in income the payments as received from its franchise members. Unsurprisingly, the IRS argued that Seven-Up and its progeny had been incorrectly decided.

The Tax Court found that the amounts contributed to the Insty-Prints Advertising Trust Fund were not income to the trust and that amounts expended by the trust for advertising were not deductible to the trust. However, the Tax Court also found that interest earned by the trust fund which was not expended for advertising was income to the trust. The court explicitly stated: “We express no opinion as whether the petitioners would be entitled to a deduction for advertising payments made from interest income.”31

More recently, the Fifth Circuit affirmed the continuing vitality of Seven-Up and Ford in Affiliated Foods, Inc. v. Commissioner.32 In Affiliated Foods, the court reversed the Tax Court’s determination that payments to a promotional account by vendors amounted to payment for services rendered to the petitioner on behalf of its members. Instead, the court found that Affiliated acted only as an intermediary for its members with respect to the funds paid by those members.


29 78-2 USTC ¶ 9658 (D.N.C. 1978).

30 T.C. Memo 1982-416.

31 Id. at 568.

32 154 F.3d 527 (6th Cir. 1998).
After this more than 60-year standoff between the IRS and our court system, a few things have become clear.

Whether the advertising fund is organized as a separate bookkeeping account or in a separate vehicle such as a non-profit corporation, trust or cooperative, it is essential that there be an explicit limitation on the use of the funds. Using a separate entity can enhance the taxpayer’s position because the governing documents can make these restrictions more specific.

It is equally clear based on this string of decisions that if the advertising fund does not recognize income on the receipt of the advertising contributions, it likewise will not be permitted to take a deduction for those expenditures. Further, as long as the advertising fund treats excess contributions as a liability and expenditures in excess of receipts as an asset, no gain or loss will be recognized.

Finally, if an advertising fund of any kind earns interest or dividend income on unexpended funds, that income will be taxable income to the fund. However, it is likely that if that interest or dividend income is expended for advertising and marketing purposes consistent with the intent of the parties, as reflected in the underlying documents, the income will be offset by such expenditures.

III. DISCLOSURE REQUIREMENTS

The FTC Franchise Rule contains a number of disclosure requirements regarding advertising and marketing funds, including requirements found in Items 5, 6, 7, 8, 9, 11 and 22:

A. Item 5 – Initial Fees

Item 5 of the FTC Franchise Rule requires disclosure of all initial fees payable by the franchisee to the franchisor or its affiliates before the business opens. If the franchisor requires initial payment toward a grand opening expense or an initial deposit into a national or local marketing fund or to a cooperative prior to the opening of the business, such fee must be disclosed in Item 5.33

B. Item 6 – Other Fees

Item 6 requires disclosure in tabular form of all fees that the franchisee must pay to the franchisor or its affiliates or that the franchisor or its affiliates impose or collect in whole or in part for any third party.34 These fees explicitly include amounts paid for advertising, advertising cooperatives and purchasing cooperatives.35 The instructions further require disclosure of the

33 16 C.F.R § 436.5(e). For example, in its Franchise Disclosure Document ("FDD") issued on April 30, 2010, Meat House Franchising, LLC disclosed in Item 5 that upon signing the franchise agreement, the franchise is required to pay $25,000 to the franchisor’s New Store Marketing Fund. See Meat House Franchising LLC FDD, dated April 30, 2010, available through the California Department of Corrections website, at http://134.186.208.228/caleasf/pub/exsearch/htm (last visited Sept. 1, 2011).

34 16 C.F.R. § 436.5(f).

35 16 C.F.R. § 436.5(f)(1).
voting power of franchisor-owned outlets on any fees imposed by cooperatives. In addition, if franchisor-owned outlets have controlling voting power, then the franchisor must disclose in Item 6 the maximum and minimum fees that may be imposed in that circumstance. Fees that a franchisee is required to pay to a franchisor-controlled advertising subsidiary or trust would be an affiliate for the purposes of Item 6 and thus payments required to be made to such an entity would be required to be disclosed. Extensive disclosure requirements regarding advertising cooperatives are found in Item 11, as described in section III.F, infra.

C. Item 7 - Your Estimated Initial Investment

Under Item 7, the franchisor must disclose in tabular form the franchisee’s estimated initial investment in the franchise business. Among the expenses required to be disclosed are payments for advertising expenses that the franchisee must make to begin operations.

The franchisor must also disclose any other required expenses the franchisee will incur during the initial period of operations, which the rule indicates is at least three months or a reasonable period for the industry. The Sample Item 7 in the FTC Compliance Guide includes the advertising fees for that three-month period, replicating the Sample Answer under the Uniform Franchise Offering Circular (“UFOC”) guidelines.

D. Item 8 – Restrictions on Sources of Products and Services

Item 8 requires disclosure of the franchisee’s obligations to purchase goods, services or other items from the franchisor, or its designee, or suppliers approved by the franchisor, or under the franchisor’s specifications.

Unlike Item 7, Item 8 does not list advertising expense as a separate disclosure item. However, to the extent that the franchisor requires the franchisee to purchase advertising from a designated source such as an advertising agency, whether in-house or independent of the franchisor, this mandate must be disclosed under this item. In that event, the franchisor will also be required to disclose the revenues it or its affiliates derive from required purchases of advertising by franchisees, as well as the percentage of total revenues of the franchisor from such purchases.


37 16 C.F.R. § 436.5(g).

38 16 C.F.R. § 436.5(g)(1)(ii).

39 16 C.F.R. § 436.5(g)(1)(iii).


41 16 C.F.R. § 436.5(h).

42 16 C.F.R. § 436.5(h)(6).
Item 8 also requires disclosure of the "existence of purchasing or distribution cooperatives."\textsuperscript{43} This aspect of Item 8 does not appear to be intended to reach advertising cooperatives, which are described in detail in Item 11.\textsuperscript{44}

E. **Item 9 - Franchisee's Obligations**

Item 9 requires the franchisor to disclose in tabular form a list of the franchisee's principal obligations under the franchise agreement.\textsuperscript{45} Row "o" of the table includes "advertising" and requires the franchisor to specify the sections in the franchise agreement and other agreements and in the disclosure document where obligations relating to advertising can be found.\textsuperscript{46}

F. **Item 11 - Franchisor's Assistance, Advertising, Computer Systems and Training**

Item 11 of the FTC Franchise Rule contains the most wide-ranging required disclosures regarding advertising and marketing. These extensive, required disclosures under Item 11 are born of the centrality of advertising in a typical franchise relationship, as well as what the FTC described in its August 25, 2004 Staff Report as "a common franchise complaint, namely, that franchisees do not get the quality or quantity of advertising they pay for."\textsuperscript{47} Indeed, the FTC Compliance Guide describes advertising as "a common and very important type of assistance."\textsuperscript{48}

The Compliance Guide also addresses franchisors that offer more than one brand or trademark for sale. Such a franchisor

...should, as a general rule, segregate its disclosures for each brand. Nevertheless, it may be impractical or unreasonable for the franchisor to segregate advertising funds by brand. In such circumstances, a franchisor may aggregate its advertising fund disclosures across its brands, as long as the disclosure makes clear that the advertising funds are aggregated across brands.\textsuperscript{49}

Disclosures in five separate areas are required:

\textsuperscript{43} 16 C.F.R. § 436.5(h)(9).

\textsuperscript{44} 16 C.F.R. § 436.5(k)(4)(iv).

\textsuperscript{45} 16 C.F.R § 436.5(i).

\textsuperscript{46} Id.


\textsuperscript{48} Compliance Guide, supra note 40, at 32.

\textsuperscript{49} Id. at 33.
1. **Franchisor's Obligation to Conduct Advertising**

Under this sub-section, the franchisor must specify the media it may use, whether the media coverage is local, regional or national and the source of the advertising (whether an in-house advertising department is used or a national or regional advertising agency). The franchisor must also disclose whether it will spend any amount on advertising in the area or territory where the franchise business is located.\(^50\)

2. **Franchisee's Own Advertising Material**

The franchisor must disclose the extent to which or the circumstances under which it will permit the franchisee to use its own advertising materials.\(^51\)

3. **Advertising Councils**

This sub-section of Item 11 requires disclosure of the existence of any advertising council composed of franchisees that advises the franchisor on advertising policies.\(^52\) The term "advertising council" is not defined in the FTC Franchise Rule, but would presumably include any committee, association or other body that advises the franchisor on that subject, including any franchisee association required to be disclosed under Item 20.\(^53\) If there is such a council, the franchisor must disclose how the members of the council are selected and whether or not the council serves only in an advisory capacity or whether it has operational or decision making power with respect to advertising expenditures.\(^54\) Finally, the franchisor must disclose the extent to which it has the power to form, change or dissolve any such advertising council. The purpose of this sub-section is to focus on whether franchisees have any input or control over how their pooled advertising funds are spent.

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\(^50\) 16 C.F.R. § 436.5(k)(4)(i).

\(^51\) 16 C.F.R. § 436.5(k)(4)(ii).

\(^52\) 16 C.F.R. § 436.5(k)(4)(iii).

\(^53\) 16 C.F.R § 436.5(t)(5).

\(^54\) For example, the 2011 form of franchise agreement for Jackson Hewitt, Inc. provides that there shall be a Marketing Committee composed of three representatives designated by the endorsed independent franchisee association and not more than six representatives of the franchisor, one which must be the franchisor’s most senior marketing executive. The committee is charged with reaching a consensus on the design, planning and implementation of the advertising and promotional campaigns and media strategy for the system, as well as the development of new products and services. If there is no consensus, the franchisor can proceed based on its built-in majority. A detailed accounting of all advertising and promotional spending is also required. The franchise agreement is available through the California Department of Corporations website, at http://186.208.228/caleas/pub/exsearch.htm (last visited Sept. 1, 2011).
4. **Local or Regional Advertising Cooperatives**

This sub-section of Item 11 requires the franchisor to disclose a substantial amount of information regarding local or regional advertising cooperatives.\(^{55}\)

The disclosure items regarding cooperatives include the following:

a. A definition of the area or membership of the cooperative.
b. The franchisee's required contribution and whether other franchisees must contribute a different amount or at a different rate.
c. Whether franchisor-owned outlets must contribute to the fund and, if so, whether on the same basis as franchisees. Note that the words "advertising cooperative" and "fund" appear to be used interchangeably in this section of Item 11; neither term is defined in the FTC Franchise Rule.
d. Whether the franchisor, franchisees, an advertising agency or some other entity is responsible for administering the cooperative.
e. Whether cooperatives must operate from written governing documents and whether those documents are available for the franchisee to review. This sub-section does not specify whether such review must occur before the franchisee signs the franchise agreement and pays the franchise fee, although in practice the governing documents of such cooperatives are rarely made available to franchisees prior to the sale. See discussion of Item 22 in section III.G, *infra*.
f. Whether the cooperative will prepare annual or other periodic financial statements and whether those statements will be available for review by the franchisee.
g. Whether the franchisor has the power to require cooperatives to be formed, changed or dissolved or merged.\(^{56}\)

5. **Other Advertising Funds**

This sub-section of Item 11 requires the franchisor to disclose whether the franchisee must participate in "any other advertising fund" without specifying the types of advertising funds to which it refers.\(^{57}\) If there is such an other advertising fund, the franchisor must make five separate disclosures regarding same. These include:

a. Who contributes to the fund?
b. How much the franchisee must contribute and whether other franchisees must contribute at a different amount or a different rate.
c. Whether franchisor-owned outlets must contribute to that fund and, if so, whether on the same basis as franchisees.
d. Who administers the fund?

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\(^{55}\) 16 C.F.R. § 436.5(k)(4)(iv).

\(^{56}\) Id.

\(^{57}\) 16 C.F.R. § 436.5(k)(4)(v).
e. Whether the fund is audited and when it is audited.
f. Whether financial statements of the fund are available for review by the franchisee.
g. How the funds were used in the most recently included fiscal year including the percentages spent on production, media placement, administrative expenses and a description of any other use.

Note that in the sub-section regarding other advertising funds, there is a requirement that the franchisor disclose whether the fund is audited and, if so, when. This is in contrast to the sub-section regarding advertising cooperatives in which the franchisor is not required to disclose whether there is or has been an audit of those entities, only whether the cooperative must prepare financial statements. It is not clear why these two different entities are not treated the same under the FTC Franchise Rule.

6. Use of Unspent Advertising Funds

Item 11 also requires disclosure of how the franchisor will use funds which remain unspent at the end of any fiscal year, including whether franchisees will receive a periodic accounting of how advertising fees are spent. In practice, a franchisor will often also disclose how it will treat any amounts it spends on advertising and marketing in excess of the contributions to the fund, whether as a loan to be repaid, with or without interest, or simply as an expense of the franchisor.

7. Franchise Sales

Finally, Item 11 requires disclosure of the percentage of advertising funds that the franchisor uses principally to solicit new franchise sales. The use of pooled advertising funds contributed by franchisees to recruit new franchisees is not an uncommon source of conflict within franchise systems. Franchisees naturally expect that the contributions they make for advertising and marketing will be used to enhance the sales at their franchised locations by increasing public awareness of and favorability toward their products and services. On the other hand, franchisors believe that all franchisees in the system will benefit by expanding the number of franchisees in the system. This increases the number of points of distribution for the products and services of the system and also provides a larger base of franchisees to contribute to the advertising fund which, in turn, will enhance the impact of advertising and marketing paid for from pooled funds.

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59 The Compliance Guide provides the following instruction with respect to production expenses: “A franchisor's internal costs associated with advertising production (e.g., supplies, photography, and computer graphics) can be characterized as production expenses. The franchisor, however, must have a reasonable basis for claiming the allocation of production expenses at the time disclosure is made. Similarly, if an advertising fund pays all or part of the salaries of franchisor personnel who are involved in the advertising of the franchise system's products or services, those costs - if reasonable - can be considered a production or administrative expense if the allocation is explained in the Item 11.” Compliance Guide, supra note 40, at 33.

59 Id.


61 16 C.F.R. § 436.5(k)(4)(vi).

G. Item 22—Contracts

Item 22 requires the franchisor to attach to the franchise disclosure document a copy of each agreement regarding the franchise offering, including the franchise agreement and any lease, options and purchase agreements. The FTC Compliance Guide states that the agreements attached should include those "...that the franchisor provides or for which the franchisor makes arrangements." This requirement may include copies of bylaws or other governing documents regarding any advertising cooperatives which the franchisee must participate in and contribute to as disclosed in detail in Item 11. Plainly, the examples given in the Item 22 instructions are not intended to be an exhaustive list of all agreements regarding the franchise offering.

IV. COLLECTION AND USE OF ADVERTISING DOLLARS

Franchise systems often have different marketing programs on national, regional and local levels. For instance, franchisees may be required to contribute a percentage of gross sales into a national advertising fund administered by the franchisor, and also may be required to spend an additional percentage of gross sales on local advertising of the franchisee's choice. The local advertising component may be accomplished through an advertising cooperative, or the franchisee may simply place ads itself in the local market. The franchisor must determine at the outset what division between national and local advertising works best for the brand.

For the most part, this paper focuses on national advertising funds, and not the local or regional components of advertising. When there is a national advertising fund to which franchisees must contribute, many issues arise with respect to the use of those funds. For example, what are the appropriate uses for franchisee advertising dollars, and how should administrative and collection expenses be paid? Are franchisees in any given geographic area guaranteed to feel the benefits of national advertising? These and other questions will be addressed in this section.

A. Collection—How and How Much?

Most franchise systems collect advertising fees as a percentage of gross sales. The cases and Franchise Disclosure Documents ("FDDs") that we have reviewed demonstrate a range between one and ten percent of gross sales. According to one publication, advertising fees most often range between one and three percent of total sales. Some franchise systems collect the advertising fee weekly (just as they do with royalties), but there are many different

63 16 C.F.R. § 436.5(v)(4).
64 Compliance Guide, supra note 40, at 50.
65 See, e.g., Broussard v. Meineke Discount Muffler Shops, Inc., 155 F.3d 331, 335 (4th Cir. 1998) (10% advertising fee); Rodgers v. Ohio Valley CFM, 774 F.2d 1163, 1165 U.S. App. LEXIS 23559, at *2 (6th Cir. 1985) (1% advertising fee).
66 ROGER D. BLAIR AND FRANCINE LAFONTAINE, THE ECONOMICS OF FRANCHISING 236 (Cambridge Univ. Press 2005). In a 1993 survey of 100 franchise agreements, 56% of the agreements required between 1% and 3% of sales to be spent on advertising. See Robert W. Emerson, Franchise Contract Clauses and the Franchisor's Duty of Care Toward Its Franchisees, 72 N.C.L. REV. 905, 968 (Apr. 1994).
options for collecting advertising dollars. For example, there could be an up-front advertising payment in a lump sum when the franchise agreement is signed, along with periodic advertising payments (also in a flat amount).\textsuperscript{67} Or, the advertising fees could be collected monthly, quarterly or annually instead of weekly.

In considering both the amount to collect and the frequency of collection, franchise systems should consider the importance of advertising to the particular brand and the types of advertising that may be funded. It may be more important to have a pre-determined advertising budget at the beginning of each calendar year, in which case a flat payment from each franchisee might be the best option. Or, a franchise system may decide that regular payments into the advertising fund (on a weekly, monthly or quarterly basis) work better for its brand. These considerations should be explored when the advertising fund is first developed.

Whether to collect advertising fees from all locations is another issue. A franchisor might want to exclude certain types of locations, such as corporate stores or unconventional locations, from the required advertising contribution.\textsuperscript{68} Alternatively, certain types of locations or franchisees might be included in the advertising fund requirement, but permitted to contribute a different (perhaps smaller) amount. Exceptions to the general rule of franchisee contribution to the advertising fund should be considered carefully, however. If certain, but not all, franchisees are required to contribute to the advertising fund, or if franchisees are required to contribute in differing amounts, a franchisor may expose itself to claims of disparate treatment.\textsuperscript{69}

Whether and how to increase the amount collected from franchisees for advertising also takes careful consideration. Franchise agreements may provide that the advertising contribution can increase either at the franchisor's sole discretion or if a majority of franchisees vote in favor of an increase.\textsuperscript{70} Given the length of many franchise agreements (which could be as long as 20

\textsuperscript{67} For example, a Re/Max franchise agreement at one time provided for a monthly advertising fee of "$50.00 for each [sales] associate under contract." See Hill v. White, Bus. Franchise Guide ¶ 11,697, n. 1 (6th Cir. Aug. 13, 1999). A 2010 form of franchise agreement for Goddard Systems, Inc. provides for a "monthly advertising contribution in the amount of $2,000 or 4% of Gross Receipts, whichever is greater." See Goddard Systems, Inc. Franchise Agreement, dated 2010, at ¶ 5.8, available through the California Department of Corporations website, at http://134.186.208.228/calesis/pub/exsearch.htm (last visited Sept. 1, 2011).

\textsuperscript{68} For example, a 2006 version of a Uniform License Offering Circular for the A&W Restaurant system provided in relevant part: "A&W does not have to require licensees operating Restaurants in the following types of locations to make the 4% contribution to the Fund: zoos, colleges and universities, fairgrounds, stadiums, airports, office buildings, hospitals, entertainment and sports complexes, bus or train stations, in-plant food service facilities, convention centers, department stores, travel plazas, mass merchandisers and military bases . . . " A&W All American Food Express Uniform License Offering Circular, dated March 24, 2006, at 20-21, available through the California Department of Corporations website, at http://134.186.208.228/calesis/pub/exsearch.htm (last visited Sept. 1, 2011).

\textsuperscript{69} See, e.g., Hall v. Burger King Corp., 912 F. Supp. 1509, 1531-34 (S.D. Fla. 1995) (granting summary judgment for franchisor on discrimination claims where plaintiff allegedly paid one-half percent more than other franchisees for rent, royalties and advertising). See also discussion of state anti-discrimination laws in section VII.E, infra.

\textsuperscript{70} A 2008 form of franchise agreement for Applebee's Neighborhood Grill & Bar provided for an advertising contribution of 2.75% of gross sales but permitted the franchisor to increase that percentage, in its sole discretion, to a maximum of 4% of gross sales at any time during the term of the franchise agreement. See Standard Form Applebee's Neighborhood Grill & Bar Franchise Agreement, dated 2008, available through the California Department of Corporations website, at http://134.186.208.228/calesis/pub/exsearch.htm (last visited Sept. 1, 2011). In contrast, the 2010 FDD for the Subway franchise system provides for a "4.5% advertising fee (or higher percentage voted by franchisees contributing to the fund)." See Subway FDD dated May 1, 2010, at 67 (on file with co-author Erika Amarante).
years), it is important for the franchise agreement to contain language that provides for the advertising contribution to change over time. In many cases, a franchisor will be able to increase the amount of an advertising contribution upon renewal of a franchise agreement. This may mean that, for a period of time, franchisees will be paying at different rates until they are all under the same form of agreement.71

Some franchisors make their own contribution to the advertising fund, whether voluntarily or as a result of a contractual or other obligation. Franchisors can “match” the franchisee contributions in some systems, or provide their own pre-determined lump payment to the fund, or contribute in a number of other ways. Franchisor contribution to the advertising fund enhances the feeling of collaboration with the franchisees that is often critical to an advertising fund – providing a sense that “we are all in this together.” Whether, and how much, to contribute to the advertising fund is another consideration for franchisors when establishing an advertising fund.

B.  Appropriate Uses – Sole Discretion / Achieving Franchisee Buy-in

The FDD, franchise agreements and other documents creating the advertising fund should set forth the appropriate uses for advertising fund dollars. It is important for the language in the documents to be clear. As detailed below, this is one of the most frequently litigated topics regarding franchise advertising funds.72

At one end of the spectrum, a franchisor can retain sole discretion to use the advertising dollars in any way it sees fit. In some systems, the franchisor may agree to restrict the use to “advertising” or “marketing” funds without any further restriction. Many franchisors state that they will control the use of the advertising funds.73 For example, a 2008 version of an Edible Arrangements franchise agreement provided in relevant part: “EA has established a Marketing Fund (the “Fund”) for the advertising, marketing, and public relations programs and materials it deems appropriate. . . . EA will direct all programs that the Fund finances, with sole control over the creative concepts, materials, and endorsements used and their geographic, market, and media placement and allocation.”74 Similarly, a Hardee’s franchise agreement contained the following language:

HFS [Hardee’s Food Systems] has established, and will maintain and administer the HNAF [Hardee’s National Advertising Fund] for the creation and development of advertising, marketing and public relations, research and related programs, activities and materials that HFS, in its sole discretion, deems appropriate. . . . HFS or its designee shall direct all advertising, marketing, and public relations

71 To address this problem, in a 2009 form of franchise agreement for the Del Taco system, the franchisor expressly “reserve[d] the right to increase the marketing fee to the then current fee that it charges new franchisees.” See Del Taco LLC Franchise Agreement, dated April 1, 2009, available though the California Department of Corporations website, at http://134.198.208.228/caeasi/pub/exsearch.htm (last visited Sept. 1, 2011).

72 See section V.C, infra.

73 A survey of 100 franchise agreements in the early 1990s revealed that 77% of the agreements provided that the franchisor would control and manage the system’s advertising. See Emerson, supra note 66, at 968.

programs and activities financed by HNAF, with sole discretion over the creative concepts, materials and endorsements used in those programs and activities, and the geographic, market and media placement and allocation of advertising and marketing materials.\textsuperscript{75}

At the other end of the spectrum, there may be a franchise system where the franchisees have sole authority to spend the advertising dollars. This is probably a rare situation, however. Since the franchisor generally owns the trademark rights and the brand, it is likely to retain some input over the direction of the brand. In the KFC franchise system, for example, the advertising fund is managed by a non-stock corporation with both franchisees and representatives of the franchisor participating in decisions. The extent of control over the advertising decisions is governed by the certificate of incorporation, and was the subject of recent litigation.\textsuperscript{76} The court concluded that the certificate of incorporation was ambiguous and gave the franchisees more control over advertising than the franchisor advocated.\textsuperscript{77} Nonetheless, the court noted that their interests generally are aligned: “The franchisees have a strong incentive to be good shepherds of the KFC brand. If the KFC brand is impaired, KFC[] franchisees stand to suffer as much as KFC[]. The franchisees would be foolish to ignore thoughtful plans proposed by KFC[], as foolish as KFC[] would be to ignore the views of those who sell directly to KFC customers.”\textsuperscript{78} The court further noted that “KFC’s fears are mitigated by the fact that KFC remains the owner of the KFC brand and its associated trademarks.”\textsuperscript{79} Thus, by licensing the brand to the independent advertising fund, KFC and other franchisors can retain some control over the direction of advertising.

The majority of franchise systems likely lie somewhere between of these two extremes, with the franchisor determining the expenditures, with input and guidance from franchisees in some form. For example, a 2010 Bruegger’s franchise agreement provides that the franchisor will retain final authority over advertising decisions, but that it “will seek the advice of owners of Bruegger’s Bakeries by formal or informal means with respect to the creative concepts and media used for programs financed by the NAC [National Advertising Council].”\textsuperscript{80} The franchisor has also established an Advisory Board that includes franchisees and has a role in determining the direction of advertising for the brand.\textsuperscript{81}

\textsuperscript{75} Hardee’s Food Sys., Inc. v. Hallbeck, 2011 U.S. Dist. LEXIS 21756, at *3-4 (E.D. Mo. 2011) (emphasis added). Despite this language, a district court refused to dismiss former franchisees’ claim that allegedly lewd TV advertising breached the implied covenant of good faith and fair dealing. See discussion of this case in sections V.D and V.F, infra.


\textsuperscript{77} Id. at 8-10, 19.

\textsuperscript{78} Id. at 19.

\textsuperscript{79} Id.


\textsuperscript{81} Id.; See also D&K Foods, Inc. v. Bruegger’s Corp., Bus. Franchise Guide ¶ 11,506 (D. Md. Sept. 30, 1998) (holding that an earlier version of the franchise agreement required the franchisor to permit franchisees to take part in the administration of the advertising fund).
C. Administrative Expenses and Overhead

Administering an advertising fund obviously brings certain administrative costs and overhead. Can those administrative expenses be paid for out of the advertising fees collected from franchisees? The answer often depends on the disclosure and other documents regarding the advertising fund.

According to one decision, a Burger King franchise agreement once provided that Burger King Corporation ("BKC") would use advertising fees "less direct administrative expenses," for the purposes of advertising and promotion.\(^{62}\) Query how one would define a "direct" administrative expense that could be paid for with franchisee advertising contributions (as opposed to an "indirect" administrative expense that could not)? More recent franchise documents contain more explicit language about what expenses and costs will be paid for out of the franchisee advertising contributions. For example, a 2008 version of the Edible Arrangements franchise agreement contained detailed language on the administrative costs for which franchisee advertising contributions might pay:

EA may use the Fund to pay the reasonable salaries and benefits of personnel who manage and administer the Fund, the Fund's other administrative costs, travel expenses of personnel while they are on Fund business, meeting costs, overhead relating to Fund business, and other expenses that EA incurs in activities reasonably related to administering or directing the Fund and its programs, including, without limitation, conducting market research, public relations, preparing advertising, promotion, and marketing materials, and collecting and accounting for Fund contributions.\(^{63}\)

In some franchise systems, employees of the franchisor will manage and provide administrative support to the advertising fund, in order to reduce overhead. If a franchisor intends to be reimbursed for these services, the disclosure documents should say so.\(^{64}\)

To protect the franchisees' advertising contributions, some franchise systems place a cap on the amount of the advertising fees that can be used for administrative costs. For example, for some period of time, the Dunkin' Donuts franchise agreement provided for a 5% advertising contribution and expressly provided that only 1% could be used for administrative expenses.\(^{65}\) Not surprisingly, a limit like this can lead to litigation over how to characterize certain expenditures and whether the allowable expenses exceed that cap.\(^{66}\)

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\(^{64}\) See Rodgers v. Ohio Valley CFM, 774 F.2d 1163, 1985 U.S. App. LEXIS 23559 (6th Cir. 1985) (affirming jury verdict finding that franchisor misused advertising funds when money went to overhead, operating and other expenses and those expenses were not disclosed to franchisees).


\(^{66}\) For example, in Dunkin’ Donuts, Inc. v. N.A.S.T., Inc., Bus. Franchise Guide ¶ 12,630 (N.D. Ill. Apr. 11, 2003), a franchisee challenged the characterization of certain expenses as advertising expenses, arguing that they should really be administrative expenses subject to the cap. The court rejected this challenge, relying on the fact that an independent auditor (Ernst & Young) was responsible for categorizing the expenses. Id. at 5.
Disputes can also arise over whether the payment of litigation expenses can be an administrative expense properly charged to the advertising fund. This issue arose in litigation concerning both the Meineke and Subway franchise systems. Specifically, Meineke franchisees alleged that it was improper to use over $1 million in franchisee advertising contributions to defend and settle a lawsuit brought by a third-party advertising agency for past and future commissions. In the Subway system, the franchisor asserted counterclaims against the trustees of the Subway Franchisee Advertising Fund Trust, alleging that franchisee advertising contributions were used improperly to fund several lawsuits against DAI.

D. Collection Expenses

Another preliminary logistical question is who collects the advertising dollars from the franchisees, and how? Even with a separate fund, it may be that the franchisor will collect the advertising fees with royalties, for administrative ease. Collection can create an additional administrative expense if the advertising fund has to do it all itself.

What happens if a franchisee refuses to pay the advertising fee? What entity (franchisor or independent advertising fund) can enforce the contract? If the franchisor collects the advertising fees from franchisees directly, then the franchisor may take direct action for underreporting or refusals to pay. However, in those franchise systems where the advertising fund is a separate entity that collects the fees directly from franchisees, what role can the franchisor play when a franchisee refuses to pay the advertising fee or underreports gross sales?

Most franchise agreements provide that failure to pay the advertising fee to the advertising fund is a breach of the franchise agreement. Thus, the franchisor can hold the underpaying franchisee in default for a breach of the franchise agreement. The independent advertising fund might also need to take action to recover the overdue advertising funds, whether through arbitration or litigation. In the case of an underreporting franchisee, both royalties (to the franchisor) and advertising fees (to the separate fund) would be due. Because it is more efficient to recover royalties and advertising fees in a single arbitration or lawsuit, most often the franchisor and the advertising fund will enter into an arrangement that permits the franchisor to recover these funds on behalf of the advertising fund.

Does the administrative cost of those collection efforts then get charged to the advertising fund? The answer will depend on the language in the franchise agreement and disclosures. The 2008 form of Edible Arrangements' franchise agreement specifically provides that “EA has the right, but no obligation, to use collection agents and institute legal proceedings to collect Fund contribution at the Fund's expense.” Where the document language is not as clear, the parties may dispute how to pay for collection efforts. For example, in Moghaddam v. Dunkin’ Donuts, Inc., the franchise agreement provided that only 1% of the 5% collected

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67 Broussard v. Meineke Muffler Shops, Inc., 155 F.3d 331 (4th Cir. 1998). See also discussion of this case in sections V.C, V.E, and V.H, infra.

68 See Offutt v. Doctor's Assoc., Inc., 3:07 CV 00363 (D. Conn.). See also discussion of this case in sections IV.E, V.B and V.E, infra. Co-author Erika L. Amarante was counsel for Doctor's Associates Inc. in this matter.

advertising fees could be used for administrative expenses. When several franchisees sued the Dunkin’ franchisor over the use of advertising funds to cover collection expenses, the district court granted the franchisor’s motion for summary judgment based on the contract language, holding: “Nothing in the agreement specifically prohibits Dunkin’ from exercising its discretion to allocate administrative expenses of the Fund for loss prevention related to advertising (subject, of course, to the 20 percent cap).”

E. Audits and Inspections

Many franchise agreements provide that the franchisor and/or advertising fund must provide an accounting to the franchisees. In those situations, failure to provide the accounting may provide a basis for a breach of contract claim.

Where an advertising fund is independent from the franchisor, the franchisor also may retain the right to audit and inspect the books and records of the advertising fund. In Offutt v. Doctor’s Associates, Inc., for example, the franchisor of the Subway system filed a counterclaim against the trustees of the Subway Franchisee Advertising Fund Trust (“SFAFT”) for, among other things, failure to provide access to SFAFT’s records and books as set forth in the Trust Agreement that established SFAFT. The court never resolved those claims due to a settlement.

F. Geographic Allocations

Whether to use advertising funds on a national level or more locally can be hotly contested, with views varying based on the type of product and brand. Some franchisee advertising funds are meant to fund national advertising only, with local advertising coming out a different fund or left to individual franchisees. This is another area where the documents should be clear.

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90 Mohr v. Dunkin' Donuts, Inc., 322 F. Supp. 2d 44, 46 (D. Mass. 2004). Specifically, the language of the franchise agreement provided: “That portion of FRANCHISEE’s advertising contribution equal to one percent (1%) of the Gross Sales of the Shop will be utilized, at the discretion of DUNKIN’ DONUTS, to provide for the administrative expenses of the Fund and for programs designed to increase the sales and enhance and further the image of DUNKIN’ DONUTS and the Dunkin’ Donuts System. The balance, including any interest earned by the Fund, will be used for advertising and related expenses.” Id. at 48 (quoting Section 3.5 of the Franchise Agreement).

91 Id. at 47-48. The court went on to state: "I agree with Dunkin' that it must only repay advertising fees to the Fund after a fair allocation of the costs of collection. However, it would be a breach of good faith and fair dealing not to repay into the Fund any net advertising fees (after costs) recouped." Id. at 48.


93 Case 3:07 CV 00363 (D. Conn.). See also discussion of this case in section IV.C, supra, and in sections V.B and V.E, infra.

94 The Trust Agreement provided in relevant part: "The Trustees shall keep accurate and detailed records of all investments, receipts, disbursements and all other transactions of the Trust Fund. All such accounts, books and records shall be open to inspection at all reasonable times, upon reasonable written request, by each Franchisee and by the Settlor [DAI]." Trust Agreement, § 8.1.

95 For example, a Quizno’s franchise agreement from 2006 provides that franchisees contribute 1% of gross sales into an advertising fund administered by the franchisor, and also must spend an additional 3% of gross sales each quarter for local advertising. See Quizno’s Franchising II LLC Franchise Agreement dated March 2006, at ¶¶ 12.3 &
It is important to clarify whether a franchisee should expect to see any direct, or proportional, benefit from their contributions to the pooled advertising fund. Many of the franchise agreements that leave advertising in the "sole discretion" of the franchisor also provide that the franchisee is not guaranteed to feel the benefit of the funds. For example, a franchise agreement in the Popeyes system once provided: "Franchisee understands that such advertising is intended to maximize the public's awareness of POPEYES Famous Fried Chicken restaurants, and that Franchisor accordingly undertakes no obligation to insure that any individual franchisee benefits directly or on a pro rata basis from the placement, if any, of such advertising in his local market." Similarly, in the Hardee's franchise system, the franchisor expressly disclaims any "obligation to ensure that expenditures by HNAF [Hardee's National Advertising Fund] in or affecting any geographic area (including the Franchised Location) are proportionate or equivalent to the contributions to HNAF by Hardee's Restaurants operating in that geographic area, or that any Hardee's Restaurant will benefit directly or in proportion to its contribution to HNAF from the development of advertising and marketing materials or the placement of advertising." This type of language properly discloses the fact that franchisees in some areas may pay more into the advertising fund than they receive back in advertising.

G. Loans To and From Advertising Funds

It is important to have separate accounting for franchisee advertising contributions, even if the funds are maintained in the same account. Loans to or from the advertising fund must be properly documented and disclosed to franchisees, especially if it is the franchisor that is borrowing money from the fund (as opposed to the other way around). It is important to disclose any possible loans to or from the advertising funds in the FDD (even if the FTC Franchise Rule does not specifically require such a disclosure). Further, the franchise agreement should specifically reserve the right to the franchisor to loan money to or borrow money from the advertising fund, with a clear description of how the loan process will work.

V. LITIGATION OVER ADVERTISING FUNDS

Litigation over advertising funds can take several forms. Many cases arise when a franchisor has terminated a franchise agreement and sues the former franchisee for trademark

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98 For example, a March 2009 franchise agreement for the Century 21 franchise system expressly provided that "The [National Advertising Fund] may borrow from us or other lenders to cover its deficits." See Century 21 Real Estate LLC Real Estate Franchise Agreement, dated March 2009, at ¶ 8.4.2, available through the California Department of Corporations website, at http://134.186.208.228/ca/eleasipub/exsearch.htm (last visited Sept. 1, 2011). Similarly, a December 2006 form of franchise agreement for Jimmy John's Franchise, LLC provided that "The Fund may spend in any fiscal year more or less than the total Fund contributions in that year, borrow from us or others (paying reasonable interest) to cover deficits, or invest any surplus for future use. We will use all interest earned on Fund contributions to pay costs before using the Fund's other assets." See Jimmy John's Franchise, LLC Franchise Agreement dated Dec. 2006, at ¶ 9.B, available through the California Department of Corporations website, at http://134.186.208.228/ca/eleasipub/exsearch.htm (last visited Sept. 1, 2011).
violations and overdue royalties and advertising fees; the franchisee will then counterclaim with allegations concerning the improper use or administration of the advertising fees, among other claims. These counterclaims are rarely successful. Alternatively, franchisees and/or independently-established advertising funds may sue a franchisor when there is a disagreement over the language of the contract or other document that created the advertising fund. Prime examples of these lawsuits occurred recently in the Subway and KFC franchise systems, as explained below.

A. Contractual Obligations

Because advertising funds are often created by contract, breach of contract claims are very common. Many breach of contract claims focus on a claimed misuse of advertising funds. In those cases, which are discussed infra at section V.C, the language of the franchise agreement and FDD will often prevail. Other contract disputes also highlight the importance of drafting clear language in the contract.

For developing franchise systems, whether and how to establish an advertising fund can lead to litigation over contract terms. For example, in Microtel Franchise and Development Corporation v. Country Inn Hotel, a terminated franchisee counterclaimed against the franchisor plaintiff, alleging fraud and breach of contract based on, among other things, the franchisor’s failure to establish a national advertising fund. The district court dismissed the counterclaims for failure to state a claim. Where the franchise agreement provided that “Franchisor reserves the right to establish, maintain, and administer an Advertising Fund,” the court held that Microtel’s obligation to do so was discretionary and could not provide the basis for a breach of contract claim. The fraud claim also failed because the alleged promise to establish an advertising fund was a promise of future performance, not a statement of present fact that could constitute fraud.

In Honey Dew Associates, Inc. v. Creighton Muscato Enterprises, Inc., a franchisor sued several franchisees for failure to contribute to the centralized advertising fund. The franchisees counterclaimed, asserting that the advertising fund was not valid because there had not been a formal vote of all existing franchisees to establish the fund. The franchise agreement obligated the franchisee “to participate in and contribute to all advertising, marketing and promotional programs and other programs of HDA which, from time to time, are supported by a majority of full producing Honey Dew Donut Shops.” The appellate court rejected the argument that this language required a formal vote of all franchisees as a condition precedent to requiring advertising contributions; concluding that the phrase “supported by a majority” did not require an official vote.


100 Id. at 418-19.

101 Id. at 417.


103 Id. at 242.

104 Id. The court also held that only the franchisee whose agreement contained this language was bound to contribute to the advertising fund. A second franchisee whose agreement did not contain this same language was not bound to contribute to the fund, even though it shared the same principal as the first franchisee. Id. at 243.
Claims that a franchisee failed to benefit directly from advertising also arise as breach of contract claims. In Gregory v. Popeyes Famous Fried Chicken and Biscuits, Inc., a Detroit franchisee sued the Popeyes franchisor, asserting that the franchisor had provided too little advertising in Detroit. The district court dismissed this claim based on the clear language in the franchise agreement, and the Court of Appeals affirmed. Accordingly, the Court held that "Popeyes was not obligated to allocate [plaintiff's] payments to Detroit area advertising."

A district court considered the same language in a Popeye's franchise agreement in Clark v. America's Favorite Chicken. There, Popeyes franchisees alleged that, since the merger of Popeyes and Church's Fried Chicken Inc. ("Church's") in 1989, the company's marketing policies had favored Church's as a less expensive fried chicken outlet. The district court granted summary judgment for the franchisor on this claim, based on uncontroverted evidence that "Popeyes and Church's maintain distinct marketing policies to which the other is not privy." The court also relied on the language quoted in the Gregory case above to establish that advertising "need not benefit plaintiffs" directly. Affirming the grant of summary judgment for the franchisor in the Gregory case, the Court of Appeals for the Fifth Circuit held:

[A]ppellants have failed to show any evidence that AFC [America's Favorite Chicken] improperly manipulated the two systems. To the contrary, uncontroverted summary judgment evidence established that the marketing departments for the Popeyes and Church's systems are carefully segregated, that marketing policy for the two systems, other than in the broadest of senses, is made independently, and that no confidential sales information is shared between the systems. Appellants' unsupported allegations that AFC was leaking confidential marketing information to competing Church's restaurants in their area falls far short of creating a genuine issue of material fact.

The difficulties of merging two competing brands, and successfully advertising for them both, became apparent when United Parcel Service ("UPS") acquired Mail Boxes Etc. ("MBE") in 2001. In G.I. McDougal, Inc. v. Mail Boxes Etc., plaintiff MBE franchisees alleged that,

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105 857 F.2d 1474, 1988 U.S. App. LEXIS 12304 (6th Cir. 1988). See also discussion of this case in section IV.F, supra.

106 Id. at *12. The language in the franchise agreement is quoted supra in the text surrounding footnote 97.

107 Id. at *11. See also America's Favorite Chicken Co. v. Cajun Enters., Inc., 130 F.3d 180 (5th Cir. 1997) (affirming dismissal of breach of contract claim based on alleged failure to allocate sufficient advertising funds to a local market); Biscuit Investments, Inc. v. Cajun Enters., Inc., 1991 U.S. Dist. LEXIS 3734 (E.D. La. Mar. 27, 1991) (rejecting claim that alleged failure to provide local advertising breached the Popeyes franchise agreement, relying on the same language and the Gregory decision).


109 Id. at 590.

110 Id.

111 110 F.3d 295, 299 (5th Cir. 1997).

after the merger, UPS wrongfully diverted MBE national advertising funds, used those MBE funds solely for the benefit of UPS stores and abolished the national media fund for MBE Centers while continuing to provide expensive national advertising for UPS stores. The trial court granted a defense motion for summary judgment, but the appellate court reversed, holding that there was sufficient evidence to create a triable issue of fact on the franchisees' breach of contract and other claims. In particular, the court noted evidence that the quality and availability of advertising materials for MBE franchisees had deteriorated post-merger, and also that MBE had reallocated $5 million in national marketing funds collected from MBE franchisees to advertise the UPS stores instead.\textsuperscript{113}

Contract interpretation can also lead to litigation. In \textit{KFC National Council and Advertising Cooperative, Inc. v. KFC Corp.},\textsuperscript{114} the court was tasked with interpreting the certificate of incorporation for the NCAC, a non-stock corporation founded over forty years ago.\textsuperscript{115} At issue was whether KFC had a veto power over any advertising decisions. Applying standard rules of contract interpretation, the court determined that the certificate of incorporation was ambiguous and then turned to a review of extrinsic evidence to resolve the ambiguity.\textsuperscript{116} After a detailed and lengthy review of the parties' course of dealing, the court concluded that KFC did not have veto power over NCAC decisions.\textsuperscript{117}

The court noted that the NCAC certificate of incorporation was specifically negotiated in 1997 as part of the resolution of a larger dispute about franchisor-franchisee relations.\textsuperscript{118} Pursuant to the certificate, NCAC's board of directors (called the "Committee") consisted of seventeen voting members: four appointed by KFC, twelve elected by region by the franchisees and one is the President of the Association of Kentucky Fried Chicken Franchisees, Inc. The breakdown on the Committee was therefore thirteen to four in favor of the franchisees.\textsuperscript{119}

In 2009, a dispute arose about, among other things, the advertising focus on grilled chicken versus the staple fried chicken product.\textsuperscript{120} Sections 3.3 and 3.4 of the NCAC certificate set forth KFC's authority and the Committee's authority with respect to advertising. According to Section 3.3(b) and (c), KFC "shall develop national advertising, public relations media and strategy, including advertising and media calendars and budget, and submit such plans for the approval of the Committee" and "recommend any changes in the advertising and media calendars and budget which it deems appropriate, which changes can only be implemented with the approval of the Committee."\textsuperscript{121} Based on this language, KFC argued that only it could make

\textsuperscript{113} \textit{ld.} at 8-9.


\textsuperscript{115} \textit{ld.} at 2.

\textsuperscript{116} \textit{ld.} at 8-17.

\textsuperscript{117} \textit{ld.} at 19.

\textsuperscript{118} \textit{ld.} at 13-15.

\textsuperscript{119} \textit{ld.} at 4.

\textsuperscript{120} \textit{ld.} at 5.

\textsuperscript{121} \textit{ld.} at 7.
advertising proposals, for the Committee’s approval or disapproval. If the Committee
disapproved an advertising plan, it could not develop its own competing plan but instead must
wait for KFC to develop a new plan. In contrast to Section 3.3, however, Section 3.4(b) granted
the Committee the right to “plan and approve each ensuing year’s advertising program within
the limits of an estimated budget” developed by KFC.\textsuperscript{122} The court determined that these
provisions were “internally contradictory and overlapping,” and therefore ambiguous.\textsuperscript{123} Looking
to extrinsic evidence, the court noted that the parties had never followed the “highly formal”
process KFC was advocating.\textsuperscript{124} In fact, the evidence showed that, in the past, the franchisee
members of the NCAC had made proposals to the Committee that the Committee then voted on
without KFC objecting to the procedure. Moreover, there was also evidence that the Committee
had approved advertising proposals over KFC’s objection.\textsuperscript{125}

Further informing the court’s decision was the fact that the NCAC was a non-stock
corporation. According to the court, “[a]lthough this Certificate is not like many certificates of
incorporation in that it was bilaterally negotiated, the regular order of majority rule by the
corporate board – in this case, the Committee – is an important default public policy principle
and departures from that regular order should emerge clearly.”\textsuperscript{126} In other words, according to
the court, a corporation’s electorate – here, the NCAC Committee – should not be
disenfranchised unless there is clear and convincing evidence to support that result. Applying
that rule, the court concluded that “[KFC] has not demonstrated through extrinsic evidence that
the Certificate means anything other than what it more likely appears to mean on its face –
namely, that [KFC] has primary responsibility to make recommendations to the NCAC for the
Committee’s approval but that the NCAC retains the authority to make recommendations of its
own or modify [KFC]’s recommendations and then vote on those recommendations by majority
rule.”\textsuperscript{127}

B. Trust Agreements

Very few franchise systems have advertising funds that are established as a trust. In the
franchise systems that have not expressly created a trust, courts often have refused to hold that
the parties have a de facto trust relationship.\textsuperscript{128} At least one court, however, has found that

\textsuperscript{122} Id. at 7-8.

\textsuperscript{123} Id. at 8.

\textsuperscript{124} Id. at 17.

\textsuperscript{125} Id.

\textsuperscript{126} Id. at 19.

\textsuperscript{127} Id. In another case involving an advertising fund that was held in a corporation, the franchisor withdrew as a
voting member of the corporation based on an alleged misappropriation of advertising funds. The franchisor then
sued the corporation, and the trial court held that it lacked standing because it was no longer a member of the
corporation. The trial court analogized the lawsuit as a shareholder derivative suit, where only active members have
standing to sue. The Ohio Court of Appeals reversed, and held that the franchisor had standing because it was suing
about actions that occurred before the date it withdrew as a member of the corporation. See Convenient Food Mart

\textsuperscript{128} See, e.g., Thompson v. Atlantic Richfield Co., 673 F. Supp. 1026, 1028 (W.D. Wash. 1987) (rejecting claim that
advertising fees were held in trust; because “the franchise agreement explicitly denies franchisees any power to
influence ARCO’s advertising strategies, there is no reason to imply the existence of a trust rather than a simple
contractual obligation”).
there was a factual dispute over whether the parties intended the advertising fund to be established as a trust.\textsuperscript{129}

Two franchisors that clearly did establish trusts for holding franchisee advertising funds were faced with a great deal of litigation over the meaning of the trust relationship.

In 1955, Avis created the Avis System Advertising Trust ("Trust") to hold advertising contributions.\textsuperscript{130} Avis also created the Advertising and Policy Committee of the Avis Rent a Car System ("A&P Committee"), a joint committee representing Avis and all of its licenses. For many years, the A&P Committee enjoyed considerable influence and a large measure of control over advertising and other matters affecting the franchise system as a whole.\textsuperscript{131} In 1981, Avis stopped making payments to the Trust and started conducting its own national advertising for the Avis system.\textsuperscript{132} The A&P Committee and the Trust filed suit, arguing that Avis had breached the Exclusive License Agreement ("ELA") between the parties by failing to contribute to the Trust and by usurping the A&P Committee’s right to control national advertising for the Avis brand.\textsuperscript{133}

The trial court granted summary judgment on the claim that the A&P Committee had the right to control all national advertising, and issued a permanent injunction that effectively ordered Avis to cease its national advertising.\textsuperscript{134} The parties tried the remaining issues, including whether Avis was required to contribute to the Trust, to a jury.\textsuperscript{135} Although the jury concluded that Avis had agreed by its course of conduct to contribute to the Trust, the trial court granted a directed verdict based on the language in the ELA, which did not require Avis to pay any fees into the Trust.\textsuperscript{136}

The Court of Appeals of Texas reversed the grant of summary judgment, holding that Avis' competing national advertising campaign did not breach the ELA. The Court noted that Section 5 of the ELA only granted the A&P Committee "full responsibility for the Avis System National Advertising Programs as set forth in [the ELA].\textsuperscript{137} According to the appellate court:

\begin{itemize}
  \item \textsuperscript{129} See Brock v. Baskin Robbins, USA, Co., 2003 U.S. App. LEXIS 3840 (E.D. Tex. Jan. 17, 2003). The court summarized: "Defendants have called it a trust, though this is not conclusive. They represented to the IRS that its assets were not its own by virtue of its being a trust. And the contract appears to separate beneficial from legal ownership of the same. On the other hand, certain contractual language purports to avoid creating fiduciary duties... Thus, it appears at least a fact issue remains as to the intent of the parties and whether they succeeded in creating a legal trust in the form of an advertising fund." \textit{Id.} at 20-21.
  \item \textsuperscript{130} See The Advertising and Policy Committee of the Avis Rent a Car Sys. et al v. Avis Rent a Car Sys., 780 S.W.2d 391 and 780 S.W.2d 404 (1989). \textit{See also} discussion of this case in section II.B, supra.
  \item \textsuperscript{131} 780 S.W.2d at 393.
  \item \textsuperscript{132} \textit{Id.}
  \item \textsuperscript{133} \textit{Id.}
  \item \textsuperscript{134} \textit{Id.} at 406.
  \item \textsuperscript{135} \textit{Id.} at 393.
  \item \textsuperscript{136} \textit{Id.} at 395.
  \item \textsuperscript{137} \textit{Id.} at 406 (emphasis in decision).
\end{itemize}
“Nowhere does the ELA provide, as found by the trial court, that 'there is to be only one such National Advertising Program in the United States' or that the A&P Committee has full responsibility for such a program.”

In a separate opinion, the Court of Appeals affirmed the directed verdict and held that Avis did not have any duty to contribute to the Trust, noting: "[a]ppellants do not cite any authority to support their contention that they are entitled to rely on the express written contract on the one hand while at the same time contend there was an implied contract at variance with and providing terms in addition to those contained in the written contract." Thus, on both issues, the appellate court adhered to the plain language of the ELA and enforced its terms.

More recently, a dispute over the meaning of a trust agreement in the Subway franchise system led to a bench trial in Connecticut federal court. Doctor's Associates Inc. ("DAI"), the franchisor of the Subway system, entered into a Trust Agreement on November 14, 1990 to create the Subway Franchisee Advertising Fund Trust ("SFAFT" or the "Trust"). Although Subway had collected franchisee advertising funds since the 1970s, it held and administered those funds through a division of DAI, called the Franchisee Advertising Fund ("FAF"). In 1990, DAI decided to change this format, and it established the Trust. The Trust was administered by franchisee-elected trustees. Franchisees paid their advertising fees directly to SFAFT, and, for many years, DAI's franchise agreements and UFOCs expressly stated that franchisee advertising contributions would be directed to SFAFT.

In 2006, DAI changed its form of franchise agreement and amended its UFOC, to provide that franchisees would pay their advertising contributions to DAI, and DAI would then deposit the fees into SFAFT or a new advertising fund that met certain characteristics. One of the SFAFT trustees, acting on behalf of SFAFT, sued DAI over this language in 2007. At the time of the lawsuit, SFAFT was administering over $500 million annually.

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138 Id.
139 Id. at 397-98.
140 See Offutt v. Doctor's Assocs., Inc., Case 3:07 CV 00363 (D. Conn.). See also discussion of this case in sections IV.C and IV.E, supra, and in section V.E, infra.
141 Id., Complaint, dated March 7, 2007, ¶ 11.
142 Id., ¶ 10.
143 Id., ¶ 11.
144 Id., ¶ 25.
145 Id., ¶ 32-34. The April 2006 franchise agreement provided that the advertising fees would be "placed into an advertising fund managed jointly by us and elected franchisees for the benefit of franchisees in the System." Id., ¶ 38. In an October 2006 version of the franchise agreement, DAI had amended this language, to provide: "We will deposit that money into the Subway Franchisee Advertising Fund Trust ("SFAFT"), provided that SFAFT: (a) follows a transparency policy that we approve and fully discloses all material financial data about the fund to franchisees; (b) is prudent with expenses; and (c) works closely with us to produce and place advertising to enhance the SUBWAY® brand. If SFAFT does not adhere to the above requirements, we may deposit your advertising contributions into an advertising fund established for the benefit of franchisees in the System that follows those requirements."
The case hinged on an interpretation of Section 4.2 of the Trust Agreement, which provided:

The Settlor [DAI] hereby agrees that it will take all steps necessary to cause all payments made by its Franchisees to the Franchisee Advertising Fund to be paid hereafter directly to the Trust. The Settlor further agrees that (i) if it alters, modifies or cancels the provisions of its Franchise Agreements with its Franchisees (either now in existence or subsequently executed), and (ii) such action causes the payments by the Franchisees to the Trust to be reduced, encumbered or eliminated – thereafter, the Settlor will replace the Trust as the indemnitee of the Trustees under Section[s] 9.6 and 9.8 below, in respect to all actions taken by the Trustees prior thereto.146

Offutt, on behalf of SFAFT, argued that the first sentence of Section 4.2 required DAI to direct franchisee advertising contributions to SFAFT forever and in perpetuity, and rendered the 2006 versions of the franchise agreement null and void. DAI disagreed, and argued that the second sentence of Section 4.2 expressly permitted DAI to amend its franchise agreements to reduce, encumber or eliminate franchisee contributions to the Trust.

The case was tried for a week before United States District Judge Alvin Thompson in November 2009.147 During a December 21, 2009 conference call with the parties, Judge Thompson revealed his decision, stating: “I have finished my thinking, but not my writing, about [the primary] question [in the case]: Does the Trust Agreement preclude DAI from unilaterally changing the franchise agreement to divert franchisee advertising contributions away from SFAFT or the trust? And my conclusion is no, it does not preclude DAI from unilaterally changing the franchise agreements to divert franchisee advertising contributions away from the trust.”148

Judge Thompson never issued a written decision, however, because the parties negotiated and reached a settlement in the Spring of 2010.149 As part of the settlement, the parties amended the Trust Agreement, among other ways: (1) to provide that DAI has the authority to appoint the trustees of SFAFT and (2) to create an advisory board of franchisees with input on advertising decisions.

C. Misuse of Advertising Funds

Misuse of advertising funds is the most frequently litigated issue arising out of franchise advertising funds. Although these claims are usually breach of contract claims, or an alleged breach of the covenant of good faith and fair dealing, franchisees have also asserted conversion and fraud when a franchisor or advertising fund allegedly misuses advertising funds. The

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146 Id., ¶¶ 21-23.

147 A highlight of the trial was expert testimony for the defense from former Forum Chair Charles Modell, who testified concerning the practices of franchisors with respect to the organization, structure and operation of pooled advertising funds.


149 See Offutt v. DAI, Case No. 3:07 CV 00363 Doc. # 208.
success of these claims is almost always dependent on the language in the contract and disclosure documents.

Where a contract reserves sole discretion to the franchisor in determining the use of the advertising funds, it often can be difficult for a franchisee to state a claim for misuse of those funds. Often, the cases focus on whether the activity being funded qualifies as "advertising" at all. In *Sherman v. Ben & Jerry's Franchising, Inc.*, for example, a franchisee challenged, among other things, Ben & Jerry's use of franchisee advertising fees to promote a political agenda. Specifically, Ben & Jerry's promoted a "Waffle Truth" campaign that directed customers to Al Gore's website and encouraged them to buy his book or DVD. The franchise agreement provided that "Ben & Jerry's shall direct all marketing programs, with sole discretion over the concepts, materials, and media used in such programs and the placement and allocation thereof." Despite this language, the district court refused to dismiss the franchisee's breach of contract claim, holding that "[i]f the Court accepts as true, as it must, Plaintiffs' contention that these programs did not constitute advertising, the allegations suffice to state a claim." 

Similarly, a franchisee stated a claim for breach of contract for misuse of advertising funds in *Sunshine Restaurant Partners, L.P. v. Shivshakti One, Inc.* There, an IHOP franchisee challenged the use of advertising funds to support corporate stores and not the franchisee's store. The franchise agreement provided that "[a]ll matters concerning the nature, location, placement or other aspects of the advertising to be conducted with Licensee's funds pursuant to this section of the Agreement, including the geographical area to be covered by such advertising shall be determined in the sole discretion of IHOP [or Sunshine], as the case may be." Despite this language, the court refused to dismiss the breach of contract claims, finding that it would be inconsistent with the intent of the parties and the remainder of the agreement to "permit Sunshine to initiate a cooperative marketing campaign, entice franchisees within the geographic region to vote in favor of the campaign, and then use the funds for the

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152 Id. at *4.

153 Id. at *21-22.

154 Id. at *22. See also *C.K.H., LLC v. The Quizno's Master, L.L.C.*, 2005 U.S. Dist. LEXIS 42347, at *11-12 (D. Colo. Mar. 25, 2005) (refusing to dismiss breach of contract claim where franchise agreement specified certain uses for franchisee advertising contributions and the complaint alleged that the franchisor had used the funds for a different purpose). There are no reported decisions in these cases following the denial of the motions to dismiss, so the final outcome of these claims is unknown.


156 Id. at n. 3
sole purpose of promoting Sunshine's own stores, while excluding the stores of the franchisees financing the marketing campaign.\footnote{157}

In Rodgers v. Ohio Valley CFM,\footnote{158} the Court of Appeals affirmed a jury verdict finding that the franchisor had failed to use franchisee advertising contributions for advertising. The franchisor had never established individual accounts for the advertising funds, but did conduct a separate accounting. The evidence showed that, from 1970 to 1982, the franchisor collected $795,715 more in franchisee advertising fees than it had expended on direct advertising.\footnote{159} The franchisor had never disclosed to franchisees that it was charging to the advertising fund overhead, operating, or any other expenses besides direct advertising costs.\footnote{160} The jury unanimously found that the franchisor failed to spend the advertising contributions on advertising, and the Sixth Circuit Court of Appeals affirmed.\footnote{161}

In Little Caesar's Enterprises, Inc. v. Smith,\footnote{162} a group of franchisees alleged that franchisee money given to the Little Caesar's National Advertising Program, Inc. ("LCNAP") was being used for purposes other than advertising that benefits franchisees. The franchisees sued for both breach of contract and conversion.\footnote{163} Specifically, the franchisees contended that $670,000 of LCNAP funds were used to sponsor an arena football team owned by a Little Caesar owner, and another $200,000 was used to sponsor an executive's racing boat in a nationally televised racing competition.\footnote{164} The district court refused to certify a class on these issues,\footnote{165} and the parties later settled the claims.

In Broussard v. Meineke Muffler Shops, Inc.,\footnote{166} franchisees alleged that Meineke had diverted approximately $32 million in Weekly Advertising Contribution ("WAC") for purposes other than advertising. Specifically, franchisees alleged that Meineke had used a little over $1 million of WAC funds to defend and settle a lawsuit brought by a third-party advertising agency for past and future commissions when Meineke established an in-house advertising agency called New Horizons Advertising, Inc. ("New Horizons").\footnote{167} Further, franchisees claimed that New Horizons had received approximately $31 million in commissions from the WAC account

\footnote{157} Id. There are no reported decisions in this case following the denial of the motion to dismiss, so the final outcome of these claims is unknown.

\footnote{158} 774 F.2d 1163, 1985 U.S. App. LEXIS 23559 (6th Cir. 1985).

\footnote{159} Id. at *8.

\footnote{160} Id. at *8-9.

\footnote{161} Id. at *10, 28.

\footnote{162} 895 F. Supp. 884 (E.D. Mich. 1995). See also discussion of this case in section V.H, infra.

\footnote{163} Id. at 887.

\footnote{164} Id. at 889.

\footnote{165} Id. at 906.

\footnote{166} 155 F.3d 331 (4th Cir. 1998). See also discussion of this case in section IV.C, supra, and in sections V.E and V.H, infra.

\footnote{167} Id. at 334-35.
for placing advertisements, and that those high commission rates had not been properly disclosed.\textsuperscript{168} After certifying a class of franchisees and conducting a seven-week trial, the trial court entered judgment for $390 million on a variety of contract, tort and statutory claims.\textsuperscript{169} The Court of Appeals for the Fourth Circuit reversed, concluding first that the class should not have been certified,\textsuperscript{170} and second that many of the tort claims should not have been presented to the jury. According to the Court of Appeals, this case was, at bottom, a breach of contract action. "The plaintiffs in this lawsuit may have some legitimate grievance with Meineke's conduct. They retain a variety of contract remedies for any breach that may have occurred. Those remedies include, where appropriate, restitution to the WAC account and consequential contract damages in the form of franchisee's lost profits."\textsuperscript{171} The Court remanded for further consideration of the contract claims at issue.

D. \textbf{Implied Covenant of Good Faith and Fair Dealing}

Most contract claims are accompanied by a claim that the implied covenant of good faith and fair dealing has also been breached. However, courts often hold that the implied covenant cannot be used to contradict express contract terms. Thus, if the franchise agreement gives the franchisor the right to determine the use of the advertising funds in its sole discretion, then exercising that right cannot breach the implied covenant of good faith and fair dealing.\textsuperscript{172}

In some situations, however, a claimed breach of the implied covenant can succeed even when a breach of contract claim fails. \textit{Hardee's Food Systems, Inc. v. Hallbeck}\textsuperscript{173} is one example. In \textit{Hallbeck}, former franchisees asserted counterclaims for breach of contract and breach of the implied covenant of good faith and fair dealing, arising out of allegedly lewd TV commercials funded by franchisee advertising dollars. While concluding that the former franchisees failed to state a claim for violation of the express contract terms, the district court refused to dismiss the implied covenant claim regarding the nature of the advertising.\textsuperscript{174}

\textsuperscript{168} \textit{id.} at 335.

\textsuperscript{169} \textit{id.} at 336-37.

\textsuperscript{170} \textit{id.} at 337-44.

\textsuperscript{171} \textit{id.} at 352.

\textsuperscript{172} See, e.g., \textit{Burger King Corp. v. Kellogg}, 1990 Bus. Franchise Guide (CCH) ¶ 9730 (S.D. Fla. Sept. 7, 1990) (dismissing claims for breach of contract and breach of the implied covenant of good faith and fair dealing where "[t]he contract clearly gave [the franchisor] the right to advertise as it saw fit"). \textit{See also Burger King Corp. v. Agad}, 941 F. Supp. 1217, 1221-22 (N.D. Ga. 1996) (rejecting breach of contract and implied covenant claims where franchisor used advertising funds to make a $5 million donation to the American Red Cross; franchise agreement explicitly provided that "all advertising expenditures shall be at the discretion of BKC" and the franchisor argued that the donation received substantial positive publicity).


\textsuperscript{174} \textit{id.} at *11-14.
E. Breach of Fiduciary Duties

The majority rule is that a franchise agreement does not create a fiduciary relationship. \(^{175}\) Courts have routinely rejected the argument that a franchisor holding franchisee advertising contributions creates a trust or fiduciary relationship. That is especially true where the agreement expressly disclaims any fiduciary obligation, as many franchise agreements do. \(^{176}\)

Even absent an express disclaimer, courts often reject claims of a fiduciary duty breach. For example, in *Oil Express National, Inc. v. Burgstone*, \(^{177}\) the court dismissed a breach of fiduciary duty counterclaim arising out of an alleged misuse of advertising funds. The court held that the counterclaim plaintiffs had failed to allege any facts from which a fiduciary relationship could be inferred. \(^{178}\) Similarly, in *Oil Express National, Inc. v. D’Alessandro*, \(^{179}\) the court dismissed breach of fiduciary duty counterclaims and expressly rejected the claim that a fiduciary relationship existed simply because franchisees trusted the franchisor with the money in the advertising fund. According to the district court, “[t]o hold as the franchise defendants wish, then, would transform every contract into a fiduciary relationship.” \(^{180}\)

Similarly, the district court in *Collins v. International Dairy Queen*, \(^{181}\) granted the franchisor’s motion for summary judgment on franchisees’ breach of fiduciary duty claim arising out of the use of the franchisee advertising contributions. The franchise agreement specifically provided that the franchisor “reserves the right in its sole discretion to establish and organize advertising and promotion programs from time to time and Licensee agrees to participate in the

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176 See, e.g., *Prince Heaton Enters., Inc. v. Buffalo’s Franchise Concepts, Inc.*, Bus. Franchise Guide (CCH) ¶ 11,852 (N.D. Ga. 2000) (granting motion to dismiss breach of fiduciary and other claims based on the administration of advertising funds, where the franchise agreement expressly disclaimed a fiduciary relationship); *D&K Foods, Inc. v. Bruegger’s Corp.*, Bus. Franchise Guide ¶ 11,506 (D. Md. 1998) (granting motion to dismiss fiduciary duty claims where franchise agreement “specifically state that no fiduciary relationship was created between the signing parties”); *Burger King Corp. v. Kellogg*, 1990 Bus. Franchise Guide (CCH) ¶ 9730 (S.D. Fla. 1990) (dismissing breach of fiduciary duty claim where franchise agreement expressly disclaimed the presence of a fiduciary relationship); *C.K.H., L.L.C. v. The Quizno’s Master, L.L.C.*, 2005 U.S. Dist. LEXIS 42347 (D. Colo. 1985) (dismissing breach of fiduciary duty claim where franchise agreement specifically provided that the parties’ "only relationship is by virtue of this Agreement and that no fiduciary agreement is created hereunder").

177 958 F. Supp. 366 (N.D. Ill. 1997). See also discussion of this case in sections V.F and V.G, infra.

178 *ld. at 371.

179 1997 U.S. Dist. LEXIS 6963 (N.D. Ill. 1997). See also *Oil Express Nat’l, Inc. v. Latos*, 966 F. Supp. 650, 652 (N.D. Ill. 1997) ("defendants’ claim for breach of fiduciary duty rests on the mere trust it placed in Oil Express to fulfill its contractual duties. This is not enough to create a fiduciary duty.")


181 54 F. Supp. 2d 1351 (M.D. Ga. 1999). See also discussion in section V.H, infra.
cost and expense thereof by the payment to the Company of an advertising fee . . . "182 In the face of this language, the court rejected the franchisees’ claim that the advertising contribution created a fiduciary relationship.183

In Broussard v. Meineke Muffler Shops, Inc.,184 the Court of Appeals reversed a jury verdict on breach of fiduciary duty claims against the franchisor, holding that there was no fiduciary duty as a matter of law. "By all lights, Meineke franchisees are independent, sophisticated, if sometimes small businessmen who dealt with Meineke at arms’ length and pursued their own business interests. . . . [T]hese circumstances do not give rise to a fiduciary relationship."185 In so holding, the Court of Appeals also cautioned against the dangers of turning a contract claim into a tort claim with allegations of fiduciary duty. According to the Court of Appeals, the jury’s $350 million verdict resulted from a misconception about the basic character of the lawsuit. "At bottom then, this lawsuit centers on a dispute between Meineke and its franchisees over the interpretation of different FTAs [Franchise and Trademark Agreements] and over Meineke’s performance under those FTAs. This is a straightforward contract dispute, yet it somehow managed to become a massive tort action in the end."186

Similarly, in Cottman Transmission Systems, LLC v. Kershner,187 the district court dismissed several tort claims related to franchisee advertising contributions and held that the dispute between the parties arose solely from the license agreements.188 Rejecting the claim that the franchisor's agreement to purchase advertising on behalf of the franchisees created a fiduciary duty, the court noted:

"[T]he relationship envisioned by the Licensing Agreement is not a fiduciary relationship in which Cottman worked for the sole benefit of the Franchisees and under their control. Rather, it was a relationship in which Cottman had control and made decisions for the mutual benefit of the parties. . . . The Franchisees have failed to allege that they had an entitlement to supervise Cottman’s expenditure of the funds or that Cottman has any duty to make an accounting to them."

In contrast, in franchise systems with an actual trust for holding franchise advertising contributions, there may be a fiduciary duty to manage the funds appropriately. As discussed above, in Offutt v. Doctor's Associates, Inc.189 DAI filed counterclaims against the franchisee

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182 Id. at 1353.
183 Id. at 1354.
184 155 F.3d 331 (4th Cir. 1998). See also discussion of this case in sections IV.C and V.C, supra, and in section V.H, infra.
185 Id. at 348.
186 Id. at 345-46.
188 Id. at 555.
189 Id. at 557.
190 Case No. 3:07 CV 00363 (D. Conn.), as discussed supra in section V.B.
trustees of SFAFT, alleging misuse of the advertising contributions that breached the trustees' fiduciary duties. Specifically, DAI alleged, among other things, that the trustees had failed to open the Trust's books and records for DAI inspection, and also had voted to use Trust funds to pay a former trustee's litigation expenses in a personal lawsuit against DAI and its founder. The court never resolved these allegations because the parties reached a global settlement in the spring of 2010.

F. Third-Party Beneficiary Claims

There are many ways in which a third-party beneficiary claim might arise in the advertising fund context. For example, where the advertising fund is a separate entity, but is expressly mentioned in the franchise agreement between the franchisor and the franchisee, it is likely that the advertising fund is a third-party beneficiary of the franchise agreement. Thus, the fund may be able to enforce the franchisee's obligation to pay an advertising contribution, even if it is not party to a contract with the franchisee. On the flip side, if a franchisor has a contract with an independent advertising fund, franchisees may argue that they are the intended third-party beneficiaries of that contract. Whether a non-party to a contract is a third-party beneficiary will depend on the language in the contract and the law of the applicable state.

Where a franchisee contracts with a subfranchisor, courts have considered whether the franchisor is a third-party beneficiary that can enforce the agreement. In *Kitchen Investment Group, Inc. v. Buchtel Food, Inc.*, the defendant signed a franchise agreement with a subfranchisor (MJH). When the franchisor (CKI) sued the franchisee directly, the district court held that the franchisor could enforce the franchise agreement as a third-party beneficiary, noting in particular the fact that the franchise agreement required the franchisee to pay an advertising contribution directly to CKI.

Franchisees may also claim third-party beneficiary status in certain vendor agreements. In *Oil Express National, Inc. v. Latos,* for example, defendant franchisees counterclaimed that Oil Express had breached its contract with Citgo Petroleum Corporation ("Citgo"), which provided petroleum products for use in the franchisees’ stores. The contract provided that Citgo would contribute a set amount of its sales to an advertising fund maintained as a separate account, and "to be used by Oil Express for payment of advertising services performed on behalf of Oil Express or its franchisees." The franchisees claimed that Oil Express failed to place the Citgo funds into a segregated account and failed to use the contributions for advertising that would benefit franchisees. Oil Express moved to dismiss, arguing that the franchisees were not party to, nor third-party beneficiaries of, the Citgo contract. The district court disagreed, holding: "The contract clearly specified that Oil Express' franchisees, including the defendants, are to be beneficiaries of advertising from the monies contributed by Citgo. Hence, the defendants are third-party beneficiaries to the contract."  

192 Id. at 8.
194 Id. at 653.
195 Id. at 3. See also *Oil Express Nat’l, Inc. v. Burgstone*, 958 F. Supp. 366, 372 (N.D. Ill. 1997) ("The face of the supply agreement between Citgo and Oil Express clearly makes franchisees beneficiaries to the contract . . .").
G. **Accounting Claims**

Some franchise agreements require the franchisor or advertising fund to provide franchisees with an annual accounting of the franchisee advertising contributions.\(^{196}\) In those situations, failure to provide the accounting could provide the basis for a breach of contract claim.\(^{197}\)

In the absence of a contractual obligation, franchisees will sometimes seek an equitable accounting of the advertising contributions. Those claims are subject to very tough standards of equity, and are difficult to maintain. The standard for granting an equitable accounting is set forth in *Dairy Queen, Inc. v. Wood*,\(^{198}\) which provides in relevant part:

The necessary prerequisite to the right to maintain a suit for an equitable accounting, like all other equitable remedies, is . . . the absence of an adequate remedy at law. Consequently, in order to maintain such a suit on a cause of action cognizable at law, as this one is, the plaintiff must be able to show that the accounts between the parties are of such a complicated nature that only a court of equity can satisfactorily unravel them.\(^{199}\)

Applying the *Dairy Queen* test, many courts have rejected franchisee claims for an equitable accounting of the advertising contributions.\(^{200}\) Equitable accountings are unnecessary when there is another way for the franchisees to obtain the requested information.\(^{201}\) Thus, while it can be difficult for franchisees to get an equitable accounting of an advertising fund, there are other methods of obtaining such information.

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\(^{196}\) See, e.g., *Burgstone*, 958 F. Supp. at 371 (noting that the franchise agreement obligated the franchisor to provide franchisees with an annual statement outlining their contributions, the amount expended from the fund, the nature of the expenditures, and the amount remaining in the fund). See also discussion in section IV.E, supra.

\(^{197}\) See, e.g., *Physician’s Weight Loss Ctrs. of Am. v. Creighton*, Bus. Franchise Guide (CCH) ¶ 9,982, at 12-13 (N.D. Ohio 1992) (refusing to dismiss counterclaim seeking an accounting as required by the franchise agreement because there was no evidence that the requested information was provided to the counterclaim plaintiff franchisees).

\(^{198}\) 369 U.S. 469, 478 (1962).

\(^{199}\) Id. at 478 (citations omitted; footnote omitted).

\(^{200}\) See, e.g., *Burgstone*, 958 F. Supp. at 371 (dismissing claim for equitable accounting where claimants “do not allege at all that such an accounting would be extraordinarily difficult or complex”). But see *Hameed v. IHOP Franchising, Inc.*, 2010 U.S. Dist. LEXIS 115123 (E.D. Cal. Oct. 28, 2010) (applying a much more lenient standard and refusing to dismiss franchisee’s claim for an accounting of the advertising contributions, reasoning simply that there are grounds for an accounting since “a franchisor/franchisee relationship exists”).

\(^{201}\) See, e.g., *Tubby’s #14, Ltd. v. Tubby’s Sub Shops, Inc.*, Bus. Franchise Guide (CCH) ¶ 13,460, at 14 (E.D. Mich. 2006) (granting franchisor’s motion for summary judgment on claim for equitable accounting of advertising fund, because the franchisees “had a full opportunity to obtain discovery from [the franchisor] relative to misspent money earmarked for advertising” during the litigation, and therefore had an adequate remedy at law that precluded equitable relief); *Oil Express Nat’l, Inc. v. Latos*, 966 F. Supp. 650, 652 (N.D. Ill. 1997) (dismissing claim for equitable accounting where plaintiffs also pursued a breach of contract action, and therefore had a remedy at law).
H. Class Actions

Class actions alleging misuse of franchisee advertising funds have met with varied success. For example, in *Little Caesar’s Enterprises, Inc. v. Smith*, the district court refused to certify a class to resolve claims of conversion and breach of contract arising out of alleged misuse of franchisee advertising contributions. The court agreed with Little Caesar’s argument that a class was unnecessary because “[i]f plaintiffs prove their claim, Little Caesar admits that it would be forced to reimburse [the advertising fund] for the full amount of the allegedly improper expenses.” Therefore, “no benefit would be gained from certification since all the class members would benefit if the LCNP claim is decided in their favor.”

The requirements for class certification were not met in *McNerney v. Carvel*, where a purported class of franchisees challenged the use of franchisee advertising funds to promote the sale of Carvel products in supermarkets, as opposed to franchised locations. The court refused to certify the proposed Advertising Fund Class, holding that the:

> [f]ranchisees potentially falling within the Fund Class definition are not all similarly situated. Each is located in different proximity to a supermarket, if any, that engages in the sale of Carvel products and, hence, may or may not actually compete with the supermarkets as a source of supply of Carvel Products. Moreover, Carvel provides different types of advertising to different franchisees at different levels of expense, such that some franchisees may get more benefit from their advertising program than that which they have contributed while others may receive less.

Similarly, when a purported class of 7-Eleven franchisees claimed that Southland Corp. failed to spend an adequate amount of money on advertising, among other things, the district court refused to certify the class because “each 7-Eleven store is unique and the needs of each store vary.”

In *Broussard v. Meineke Muffler Shops, Inc.*, the Fourth Circuit Court of Appeals reversed the certification of a class of franchisees challenging the franchisor’s use of advertising contributions, based on conflicts of interest between different groups of franchisees with respect to the appropriate relief. Numerous franchisees had enrolled in Meineke’s Enhanced Dealer Program (“EDP”), which included a reduced royalty rate and other benefits in exchange for a release of all claims including those involved in the lawsuit. The Court of Appeals therefore

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203 *Id.* at 906.
204 *Id.*
206 *Id.* at 3.
208 155 F.3d 331 (4th Cir. 1998). See also discussion in sections IV.C, V.C and V.E, supra.
209 *Id.* at 336.
determined that there were at least three categories of franchisees within the putative class: (1) former franchisees, (2) current franchisees who accepted the EDP program, and (3) current franchisees who did not accept the EDP program.210 "Broken down this way, it is clear that the remedial interests of those within the single class are not aligned."211 Specifically, the Court noted that former franchisees would want to maximize the monetary damages, whereas current franchisees who accepted the EDP program could not benefit from a damage award at all.212 The Court further determined that the individual contracts varied substantially, the alleged oral misrepresentations made to franchisees were not conducive to class treatment, and each putative class member's claim for lost profits required individualized proof.213 Because the disparate nature of the claims precluded class treatment, the Court of Appeals reversed the certification ruling of the district court.214

In contrast, the district court in Collins v. International Dairy Queen, Inc.,215 certified a class of Dairy Queen franchisees who brought antitrust and breach of contract claims against the Dairy Queen franchisor. With respect to the advertising fund, the franchisees claimed that the franchisor charged the advertising fund an excessive management fee not permitted by the contract or reasonably related to the services provided, and generally usurped the advertising fund for its own benefit.216 The district court certified a class, despite the franchisor's argument that there are more than 500 different types of franchise agreements existing among the class members.217 According to the court, "[t]he fact that not all contracts are identical is not sufficient to overcome the apparent commonality of issues that they present."218

I. Associational Standing

Franchisee associations that sue franchisors to challenge the use of franchisee advertising contributions have met with little success. For example, in DDFA of South Florida, Inc. v. Dunkin' Donuts, Inc.,219 an association of Dunkin' Donuts franchisees sought a declaration regarding the appropriate use of franchisee advertising contributions. The district court granted Dunkin' Donuts' motion to dismiss for lack of associational standing. Applying the

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210 Id. at 338.

211 Id.

212 Id.

213 Id. at 340-41.

214 Id. at 344.


216 Id. at 672.

217 Id. at 676.

218 Id. Franchisee classes were also certified in Larry James Oldsmobile-Pontiac-GMC Truck Co. v. Gen. Motors Corp., Bus. Franchise Guide (CCH) ¶ 10,881 (N.D. Miss. 1996) and Race Buick-Pontiac-Cadillac-Oldsmobile-GMC, Inc. v. Gen. Motors Corp., Bus. Franchise Guide (CCH) ¶ 10,595 (W.D. Pa. 1994). Both cases challenged a mandatory advertising charge that General Motors imposed on all dealers equal to 1% of the dealer's invoice cost of each vehicle.

three-part test for associational standing in *Hunt v. Washington Apple Advertising Commission*, the court concluded that DDFA’s complaint did not meet the third prong of *Hunt*. Specifically, the court concluded that the complaint’s allegations of tortious conduct and breach of contract “require[] individual determinations as to whether DDI committed various torts against certain of its members and whether DDFA’s members or DDI itself complied with the provisions of the franchise agreement.” Accordingly, associational standing was inappropriate.

Similarly, when the North American Association of Subway Franchisees, Inc. ("NAASF") sued DAI, the Subway franchisor, in Connecticut Superior Court in 2006, alleging that DAI improperly modified its form of franchise agreement regarding the advertising fund, the association’s claims could not go forward in that forum. Each franchise agreement contained an arbitration clause that expressly precluded class proceedings. DAI filed federal court petitions to compel several individual franchisee members of NAASF to arbitrate, and also sought an injunction against NAASF’s state court action. In February 2007, the district court granted the petitions to compel and the requested injunction, holding that the claims in the state court lawsuit were subject to arbitration.

A federal court did not have diversity jurisdiction over a lawsuit brought by a trade association comprised of more than 47 individual owners of Gingiss Formalwear franchises. The trade association sought, among other things, an equitable accounting of the advertising funds. The court held, however, that the association was not the real party in interest in the lawsuit:

*Although GOA does not bring a claim that is labeled "breach of contract," the crux of the complaint is that defendants have breached the Franchise Agreements. The GOA is not a party to the Franchise Agreements; rather, its members, the franchisees, are... [I]t is clear that the GOA is suing on behalf of its members. While the GOA characterizes the harm as being inflicted upon itself rather than the franchisees (by way of fewer members, and therefore reduced*

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220 432 U.S. 333 (1977). *Hunt* held that "[a]n association has standing to bring suit on behalf of its members when: (a) its members would otherwise have standing to sue in their own right; (b) the interests it seeks to protect are germane to the organization's purpose; and (c) neither the claim asserted nor the relief requested requires the participation of the members in the lawsuit." *Id.* at 343.


222 See *NAASF v. DAI*, Case No. NNH-CV-06-4021494-S (Conn. Super.). Co-author Erika L. Amarante was counsel to Doctor's Associates Inc. in this case.

223 *Id.* For a related case, see *Offutt v. Doctor's Assoecs., Inc.*, 3:07 CV 000363 (D. Conn.), discussed *supra* in sections IV.C, IV.E, V.B, and V.E.

224 See *Doctor's Assoecs., Inc. v. Downey*, Bus. Franchise Guide (CCH) ¶ 13,580 (D. Conn. 2007). Co-author Erika L. Amarante was counsel to Doctor's Associates Inc. in this case.

225 *Id.* For further discussion of this and similar cases, see Edward Wood Dunham and Erika L. Amarante, DAI v. Downey: Associational Standing and Arbitration, 27 FRANCHISE L.J. 16 (Summer 2007).

dues and participation), the complaint fails to identify any right that the GOA possesses that is allegedly being violated.\textsuperscript{227}

Accordingly, the individual franchisees were necessary and indispensable parties to the lawsuit. Because joining all the association’s members would destroy complete diversity, the court dismissed the lawsuit for lack of subject matter jurisdiction.\textsuperscript{228}

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\textbf{VI. BANKRUPTCY ISSUES}

What happens to pooled advertising contributions when a franchisor files for bankruptcy protection? If the funds are held in the franchisor’s own account, it is possible that creditors may attempt to latch onto those advertising funds. This danger counsels very strongly for separate accounting for the designated advertising contributions, so that the funds are not part of the franchisor’s bankruptcy estate.

Franchisees may also file a claim against a franchisor in bankruptcy, related to advertising. For example, when the franchisor of Sizzler restaurants filed for Chapter 11 bankruptcy protection in 1996, a multi-unit franchisee from Kentucky filed a general unsecured claim for $500,000 based on a variety of breach of contract allegations.\textsuperscript{229} One of the claims was that Sizzler had failed to provide promised advertising support in the franchisee’s geographic area.\textsuperscript{230} The bankruptcy court rejected the franchisee’s claim, holding that the license agreements did not obligate Sizzler to spend advertising money in any of the marketing areas where the franchisee operated.\textsuperscript{231} Furthermore, the court held that, because there was no express contractual right to advertising support, “the implied covenant of good faith and fair dealing cannot create this type of right.”\textsuperscript{232}

If a franchisee files for bankruptcy, franchisors may seek to recover past due advertising contributions. Those claims generally proceed like any other collection action against a franchisee, and the contract terms will often prevail.\textsuperscript{233}

\textsuperscript{227} Id. at 3.

\textsuperscript{228} Id.

\textsuperscript{229} See In re Sizzler Restaurants Intl, Inc., 225 B.R. 466 (Bankr. C.D. Cal. 1998). See also discussion in section V.E, supra.

\textsuperscript{230} Id. at 473,476.

\textsuperscript{231} Id. at 470, 476.

\textsuperscript{232} Id. at 476.

VII. STATE REGULATION OF ADVERTISING FUNDS

There are five categories of state statutes that regulate or could be interpreted as regulating advertising funds. These laws relate to a duty of good faith, forced participation in advertising campaigns, sources of supply, use of advertising funds and discrimination.

A. Duty of Good Faith

Many franchise agreements reserve to the franchisor complete or sole discretion over the use and application of advertising funds contributed by franchisee.234 Four states have statutes which impose duties of good faith in the franchise relationship.

Hawaii235 and Washington236 have identical provisions which require the franchisor and the franchisee to "deal with each other in good faith." These provisions are mutual, in that they apply to both franchisor and franchisee.

Arkansas, on the other hand imposes a duty on the franchisor only to deal with the franchisee "in a commercially reasonable manner and in good faith."237

Iowa has the most extensive provision, which like the Hawaii and Washington statutes applies to the franchisor and franchisee.238 The Iowa statute imposes a good faith duty both in the performance as well as in the enforcement of the franchise agreement, defining good faith to mean "honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade."

B. Forced Participation in Advertising Campaigns

The Indiana franchise relationship law makes it unlawful for a franchise agreement to require the franchisee to participate in an advertising campaign or contest at an indeterminate expense, at an expense determined by a third party or determined by a formula, unless the franchise agreement specifies the maximum percentage of gross monthly sales or the maximum absolute sum that the franchisee may be required to pay.239 The Indiana statute also makes it an unlawful practice for a franchisor to coerce the franchisee to participate in an advertising campaign or contest or any promotional campaign, promotional materials, display decorations or materials at an expense to the franchisee, unspecified in the franchise agreement.

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238 Iowa Code § 532H.10.

239 Ind. Code § 23-2-2.7-1(11).
C. Sources of Supply

The Indiana Code makes unlawful any franchise agreement provision that requires "services" to be purchased exclusively from the franchisor or from sources designated by the franchisor if services of comparable quality are available from sources other than those designated by the franchisor.\textsuperscript{240} Presumably, such "services" would include the services of advertising agencies, media services or media outlets specified by the franchisor. The franchisor can avoid this restriction by publication of a list of approved suppliers or the imposition of a requirement that such services comply with its standards and specifications. As well, the franchisor may exercise a "reasonable right" to disapprove a supplier.\textsuperscript{241} While this provision does not apply to the "principal goods, supplies, inventories or services manufactured or trademarked by the franchisor," it likely does apply to the purchase of advertising or marketing services from sources designated by the franchisor, notwithstanding the fact that such advertising may well include and even prominently display the trademark of the franchisor.

The Washington Code prohibits a franchisor from requiring a franchisee to purchase services of the franchisor or from approved sources unless the franchisor satisfies the burden of proving that such restricted purchasing agreements are reasonably necessary for a lawful purpose justified on business grounds and do not substantially affect competition.\textsuperscript{242} The statute further provides that in determining whether a requirement to purchase services is unfair or deceptive or an unfair method of competition, the courts shall be guided by the decision of the courts of the United States interpreting and applying the antitrust laws of the United States.\textsuperscript{243}

D. Use of Advertising Funds

The Arkansas Code uniquely makes it a violation for a franchisor to collect an advertising fee from the franchisee based on a percentage of sales and not use those funds for the purpose of advertising the business conducted by the franchisee.\textsuperscript{244} This provision would presumably prevent the franchisor from using advertising contributions furnished by a franchisee to solicit the sales of new franchisees. Depending on how the court might interpret the phrase "the business conducted by the franchisee," it may even prohibit the franchisor from using such funds to advertise its company-owned locations or even franchisees outside the state in which the franchised business is located.

E. Anti-Discrimination

A Hawaii statute makes it unlawful to discriminate between franchisees in the charges for advertising services.\textsuperscript{245} However, such discrimination would not be unlawful under the

\textsuperscript{240} IND. CODE § 23-2.7- 1(1).

\textsuperscript{241} Id.

\textsuperscript{242} WASH. REV. CODE § 19.100.180(2)(b).

\textsuperscript{243} Id.

\textsuperscript{244} ARK. CODE ANN. § 4-72-206(7).

\textsuperscript{245} HAW. REV. STAT. § 483E-6(2)(c).
statute if: (1) the franchises were granted at materially different times and the discrimination is reasonably related to such differences in time; (2) the discrimination is related to programs for making franchises available to persons with insufficient capital, training, business experience, education or other qualifications; (3) is related to local or regional experimentation with or variations in products or services or business formats or designs; (4) is related to efforts by one or more franchisees to cure deficiencies or defaults; or (5) other reasonable distinction in light of the purposes of the law. 246

Washington and Illinois have similar but not identical statutes regarding discrimination in the charges offered for advertising services. 247

In the Washington statutory scheme, the franchisor may satisfy the burden of proving that such discrimination is "(1) reasonable; (2) based on franchises granted at materially different times and such discrimination is reasonably related to such differences in time; (3) is based upon other proper and justifiable distinctions and; (4) is not arbitrary." 248

The Illinois statute only applies to discrimination that will cause competitive harm to a franchisee who competes with a franchisee that received the benefit of the discrimination. However, the statute will not apply to discrimination based on or related to any one of the following: (a) franchises granted at different times, and such discrimination is reasonably related to such differences in time; (b) one or more programs for making franchises available to persons with insufficient capital, training, business experience or education, or lacking other qualifications; (c) local or regional experimentation with or variations in product or service lines or business formats or designs; (d) efforts by one or more franchisees to cure deficiencies in the operation of franchise businesses or defaults in franchise agreements; (e) reasonable distinctions considering the purposes of the statute and not arbitrary. 249

Minnesota has adopted a regulation which declares it to be unfair and inequitable for any person to discriminate between franchisees in the charges offered or made for advertising services unless any classification of or discrimination between franchisees is based on franchises granted at different times, geographic, market, volume or size differences, costs incurred by the franchisor, or other reasonable grounds considering the purposes of the Minnesota franchise disclosure law. 250

The Indiana code makes it unlawful for a franchisor to discriminate unfairly among its franchisees. 251 This bare bones provision does not refer to advertising services, but it does not limit its scope in any fashion. 252

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246 Id.
247 WASH. REV. CODE § 19.100.180(2)(c) and 815 ILL. COMP. STAT. 705/18.
248 WASH. REV. CODE § 19.100.180(2)(c).
249 815 ILL. COMP. STAT. 705/18.
250 Minn. R. 2860.4400.
251 IND. CODE § 23-2-2.7-2(5).
VIII. DRAFTING CONSIDERATIONS

A. The Franchisor Perspective

From the franchisor’s perspective, it is important to anticipate any issues that might arise with the use or administration of franchisee advertising fees, and clearly address those issues in the franchise agreement and FDD. Through litigation and experience, the language in franchise agreements and disclosure documents has evolved over time to address the conflicts that have arisen in the past. A smart franchisor will try to anticipate the new issues that might arise in the next ten or twenty years. For example, should franchisee advertising dollars be used for internet advertising, Groupon accounts, or perhaps to allow the brand to maintain a presence on Facebook or Twitter? Internet advertising and social networking may present the next generation of franchise advertising disputes. Franchise agreements and disclosure documents may soon include language to address these new technologies (if they do not already).

The evolution of the advertising provisions in a franchise agreement, thus far, have resulted in several provisions that are relatively standard for franchisors to include.

1. Keep Separate Accounting

Franchisee advertising funds should be accounted for separately, even if not segregated into a separate account or trust. It is important to keep accurate records, both to demonstrate a designated use to the IRS and to show franchisees where the money has gone. Where a single franchisor or company owns more than one brand, the advertising funds should be kept separate, especially if the brands compete. Franchise documents should be clear about what happens to any interest earned on advertising contributions, and also whether funds collected in one calendar year can be carried over and spent during the next calendar year. If advertising contributions are going to be invested or loaned to the franchisor or some other entity, the disclosure documents should clearly address this.

2. Involve Franchisees

Franchise agreements and disclosure documents should also make clear who, or what entity, will decide the appropriate uses of the advertising funds. In most instances, it is the franchisor who controls the direction of advertising, and the contract language should make that clear. Especially where the franchisor owns a trademark, it is difficult to imagine how it could give away control over the advertising for the brand. However, it is often in the franchisor’s best interests to include franchisees in the decision-making process. As the Delaware court noted in the recent KFC litigation, a franchisor would be “foolish . . . to ignore the views of those who sell directly to KFC customers.” Collaboration can be very beneficial to franchise system

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253 See discussion in section II.E, supra.

254 See discussion in section IV.G, supra.

advertising. While retaining discretion and control over advertising, franchisors should also remain open to formal and informal mechanisms for franchisees to have input into advertising decisions. Franchisee buy-in on national advertising programs can improve the success of the advertising and the entire franchise system. The delicate balance between a franchisor’s “sole discretion” — which may be necessary given the trademark rights at issue — and a collaborative atmosphere is one that should be well-planned and fully disclosed in the relevant documents. Based on experience at the local level, franchisees may be great sources for new advertising and marketing ideas that work for the brand.

3. **Disclaim Fiduciary Duties**

   It is also important for a franchisor to disclaim any fiduciary duty with respect to any advertising contributions it collects and administers. Such disclaimers have been universally upheld and enforced, and are often key to defending a claimed breach of fiduciary duty.\(^ {256} \)

4. **Disclose Administrative Expenses**

   It is also important to anticipate the possible expenses that the franchisee advertising funds will be used to pay and disclose those costs and expenses explicitly. Simply stating that advertising fees may be used for “administrative costs” may not be sufficient, since there is a broad category of expenses that may or may not fall under that umbrella. Recent franchise agreements clearly state that franchisee advertising funds may be used for salaries, benefits, travel expenses and other clearly delineated costs. In disclosures of this sort, the more detail, the better.\(^ {257} \) This is especially true if overhead expenses are going to be allocated among a franchisor with competing brands.

B. **The Franchisee Perspective**

   The franchisee lawyer, when asked to review a FDD on behalf of a prospective franchisee, is typically confronted with advertising provisions which are one-sided, reserve virtually unfettered discretion to the franchisor, and provide limited rights, benefits and protections to the franchisee. This is generally the case, whether the franchisor is a start-up organization or a mature system.

   The following approaches can be taken on behalf of a prospective franchisee or a franchisee association depending on a variety of factors including the status of the franchisor, system, culture and other factors:

1. **National Advertising Fund Trigger**

   With respect to a start-up franchisor that has no franchisees or very few franchisees who are geographically disparate, it does not make economic sense for a franchisee to contribute to a national advertising fund until the franchise system achieves a significant number of units. Until that time, it makes much more sense for the franchisee to spend advertising and marketing dollars in the local market. Accordingly, the goal of the franchisee in that circumstance is to delay the implementation of the national advertising fund contribution until the franchisor has

\(^ {256} \) See discussion in section V.E, supra.

\(^ {257} \) See discussion in section IV.C, supra.
achieved a specified number of units in the system or in the franchisee's geographic area. In fact, some franchise agreements for start-up franchisors reserve the power to implement a national advertising fund at some point in the future.

2. **Spending Caps**

Many franchise agreements require franchisees to participate in local or regional advertising cooperatives, as and when formed. Often, these franchise agreements do not specify the maximum percentage of gross sales that a franchisee can be required to contribute to such a cooperative. Even in those circumstances where there is such a maximum, the franchise agreement may not contain an overall cap on advertising spending required, taking into account the franchisees' obligations for national advertising, cooperative advertising and local advertising. Hence, the goal of the franchisee in these circumstances is to have either an agreement with the franchisor that credits payments to a cooperative for the national advertising contribution or the local marketing obligation or both. In the alternative, the franchisor should be willing to accept an overall cap of required spending across all categories of advertising and marketing expenses.

3. **Segregation of Funds**

It is in the interest of both franchisor and franchisee that the advertising fund not be treated as an asset of the franchisor. In that event, the assets of the fund will not be available to creditors of a bankrupt franchisor and may not be pledged by the franchisor as security for its own financing. Such a provision will provide legal protections to the fund and give the franchisees an enhanced feeling of security and greater willingness to participate in national advertising programs if the money is perceived as not being part of the general funds of the franchisor.

4. **Franchisee Participation**

As the requirements in Item 11 of the FTC Franchise Rule indicate, franchisees are vitally interested in how their advertising contributions are spent. Recognizing that the franchisor is the sole owner of the trademark, and is keenly interested in how that mark is portrayed and used in a public domain, it nevertheless remains true that in order for the franchisor to achieve franchisee buy-in on these decisions, it is vital that franchisees have meaningful input in the decision-making process. This does not mean that the franchisor summons the franchisees to a meeting and informs them of the decisions that have been made and when they will be implemented.

Greg Nathan, author of *Profitable Partnerships*,258 emphasizes that franchisees value the quality of the relationship with the franchisor as much as the financial performance of the franchised business. In a recent article, he cites the following case study:

Take the following case study of two franchise systems, Company A and Company B. While both companies had been franchising for a similar time and were similar in size and industry category, they had distinctly different corporate cultures.

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258 **GREG NATHAN, PROFITABLE PARTNERSHIPS** (7th ed. 2007).
Company A was led by an authoritarian, task focused management team, obsessed with control and which habitually dealt with franchisee conflict in a confrontational manner. Their typical approach to dealing with franchisees was to catch them out for non-compliance and take a punitive approach by issuing breach notices. Only 50% of franchisees in this company believed their franchisor cared whether they succeeded or not.

Company B on the other hand was led by a people focused management team committed to collaboration and resolving conflict through open discussion. Their modus operandi was “be constructive, not destructive” and they focused on positive two-way communication and rewarding franchisees for good performance and behavior. In this company over 80% of franchisees believed their franchisor cared whether they succeeded or not.

Despite franchisees in Company A making on average of 30% more profit, the franchisees in Company B were significantly more satisfied on a range of measures including achievement, which included financial performance....

In order for the franchisor to achieve buy-in with respect to its advertising and marketing and thus to avoid the strife and conflict that often happens in franchise systems, the franchisees need to be seen as stakeholders in the process, and as invested as is the franchisor. Whether this is done through a franchise advisory council, an independent association or a more formalized trust instrument, is largely immaterial.

5. **Transparency**

Leaving aside the issue of whether or not fiduciary duties should apply to the franchisor's administration of an advertising fund, one of the most efficient ways of dispelling franchisee concerns about the use and application of those funds is to provide annual accountings to franchisees. It is certainly possible to balance the need of the franchisees to receive meaningful and detailed information regarding how their advertising dollars are spent and the need of the franchisor to keep certain elements of the franchise system's advertising and marketing plans and strategies confidential and proprietary and out of the view of competitors.

In this regard the case of *D&K Foods Inc. et al v. Bruegger's Corp.*, is instructive. That case involved a franchise agreement under which the franchisor was required to conduct an annual audit of the ad fund. One of the claims made by the franchisees was that the franchisor had conducted such an audit, but refused to provide it to the franchisees because the franchise agreement while requiring the audit, did not explicitly require the audit to be distributed to the franchisees. The court, in refusing to dismiss the franchisee's claim on this count, stated that the franchisor's obligation "to employ an accountant to conduct an annual audit of the fund would be meaningless unless it also implies an obligation to distribute the results of the audit to the franchisees."

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259 Nathan, *supra* note 7, at 12.


47
6. **Limits on Discretion**

Franchisees should seek limitations in the franchise agreement with respect to the following:

a. A use of advertising funds to engage in the sale of franchises;
b. The payment of overhead or other administrative expenses of the franchisor from the ad fund;
c. Ensuring that the franchisee receives a reasonably proportionate benefit from the use of the advertising funds;
d. That the franchisor does not use the advertising fund to promote other brands or other systems;
e. That the franchisor does not use the ad fund primarily to promote the sales at company-owned locations; and
f. That the franchisees' contributions to the advertising fund are not used to create deep discount promotions which require the franchisees to sell goods or services below breakeven.

In *Sunshine Restaurant Partners, LP v. Shivshakti One, Inc.*[^281] the franchisee voted along with others to create an advertising cooperative in its territory. In its complaint, the franchisee alleged that the franchisor had used the funds contributed to the cooperative to promote its own company-owned stores, to the exclusion of franchised stores. The franchisor's position was that even if this was true, the franchise agreement reserved to the franchisor sole discretion over the use of the funds. Declining to dismiss this claim, the court opined that the undoubtedly broad discretion reserved by the franchisor did not permit the franchisor to engage in conduct which was inconsistent with the intent of the parties as gleaned from the franchise agreement as a whole. It did not make sense, said the court, to allow the franchisor to "entice the franchisees" to vote for the creation of an advertising cooperative and then use the funds solely to promote its own restaurants to the exclusion of the franchisees that were being asked to help finance the advertising campaign.

IX. **CONCLUSION**

Advertising is vitally important to any brand. When establishing an advertising program, new and existing franchise systems have a number of choices to consider, such as: whether to require franchisees to contribute to an ad fund, how much each location should contribute, and how to spend the money. The history of franchisee advertising funds, and litigation surrounding them, has led to many lessons for both franchisors and franchisees. Moving forward, franchise systems will need to incorporate those lessons and anticipate change for the future of franchise advertising.

[^281]: Bus. Franchise Guide (CCH) ¶14,022 (S.D. Fla. 2008). See also discussion of this case in section V.C, *supra.*
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