

**AMERICAN BAR ASSOCIATION  
35<sup>TH</sup> ANNUAL FORUM ON FRANCHISING**

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**KEEP IT SIMPLE!  
DRAFTING A PRAGMATIC FRANCHISE AGREEMENT  
AGAINST THE BACKDROP OF OVER FIFTY YEARS  
OF FRANCHISE LAW PRECEDENT**

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**I. INTRODUCTION**

The origin of franchising is a bit of a mystery. Was it started by the Romans? Was it started by Singer's effort to sell their sewing machines? We may never know the answer. What we do know is it really began to catch on as a business model in the latter half of the twentieth century in the United States. After franchising began to thrive, investigations uncovered the domination of some franchise companies by ex-convicts and persons under indictment.<sup>1</sup> In the midst of this growing and chaotic environment came the formation of the International Franchise Association in 1959 and on its heels came government regulation, starting with California's Franchise Investment Law in 1971. During these early years attorneys (and courts) were left to argue disputes and cases of first impression. This led to a slew of landmark cases in the decades that followed. Today, franchise attorneys (and courts) have many years of franchise legal precedent to guide them in their efforts. For attorneys who draft franchise agreements, an equally perplexing mystery may be how best to use their knowledge of such precedent.

The purpose of a franchise agreement is to memorialize the terms of a franchise relationship between a franchisor and a franchisee. Conventional wisdom calls for agreements to be short, concise and clear. On the other hand, seasoned counsel understand the wisdom of including terms and conditions that experience suggests will be needed to govern the working relationship of the parties to the agreement. Where to draw the line between these two conflicting principles is unique to each franchise system. This presentation will focus on how franchise attorneys should balance this knowledge with the need to keep franchise agreements concise and clear.

In order to accomplish this task we will explore in detail eleven different types of franchise agreement provisions: territorial rights and restrictions, product and service sourcing, default and termination, covenants not to compete, waivers, indemnification of the franchisor, transfers, renewals, choice of law, forum selection and venue, alternative dispute resolution and the integration clause. We will discuss the purpose of each provision, as well as compare examples of provisions we consider "overly complicated" found in publicly available franchise agreements. Along the way, we challenge you to think about the provisions included in each section. Draw on your own experiences and knowledge and ask yourself whether you agree with our conclusions of what type of provisions are too long or verbose versus what we think may be better models to customize for franchise systems you represent.

It could be said that attorneys who draft franchise agreements are a bit like doctors who diagnose and treat patients. Should doctors diagnose patients by taking all necessary precautions regardless of the time it takes and the cost involved without using their common

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<sup>1</sup> Statement of Business and Purpose, 43 F.R. 59621 at 59644 and fn. 19 (Dec. 21, 1978).

sense? Or should they be guided by common sense and the goal of finding simple and cost effective solutions, while still looking out for the best interests of their patients? Now think about this example when it comes to drafting a franchise agreement. While it is important to consider the decades of franchise legal precedent that are available to us, is it important to try and include language that addresses all of this legal precedent in every franchise agreement? While it is important to anticipate what may happen in the future, is it really critical to try and anticipate “absolutely everything” that might happen in the future? Like some doctors it is arguable that some franchise lawyers may know too much for their own good. Armed with this knowledge we are faced with the dilemma of how to incorporate decades of precedent and follow the general rule of thumb that “less is more”. Neither approach is necessarily wrong. Neither approach will necessarily lead to a poorly crafted franchise provision. However, we respectfully suggest that the latter is the preferred way for franchise attorneys to work to draft franchise agreements in a clear and concise manner, using plain English, while being guided (not driven) by precedent. Striking the right balance is not easy and one size does not fit all franchise systems. However, attempting to find the right balance is likely to lead to a stronger overall agreement and increase the odds of enforceability.

## **II. TERRITORIAL RIGHTS AND RESTRICTIONS**

### **A. What is the Purpose of the Provision?**

Territorial protection represents the franchisor’s commitment to refrain from operating or granting any other entity the right to operate an additional unit under the same brand within a specified geographic market for a defined period of time. There may be some exceptions included. Typically, these may include already existing units in the territory and a replacement for each such existing unit as well as other branded concepts that the franchisor may own or acquire in the future. Generally, territorial protection is desired by the franchisee so that it can be assured that the franchisor will not be adding additional units in close proximity that would compete for the same customers.

Many franchise systems utilize location-based franchising. When the franchisee operates out of a fixed location (e.g., store, restaurant, hotel), the license granted under the franchise agreement is for that particular location and the territorial protection is in place around that geographic location. In other systems, a mobile franchisee may market its goods or services away from a fixed location. In those systems, it is not uncommon for the franchisor to include a primary area of responsibility for the franchisee. This could be appropriate for certain service franchises (e.g., domestic services, janitorial services) in order to establish the specific territory in which the franchisee can make its sales.

The franchise agreement should also specifically reserve for the franchisor the ability to operate and grant others the right to operate same-branded units outside of the territory and within the territory once the protection period has expired or terminated. Additionally, if the franchisor desires the right to sell products or services within the territory through alternative distribution methods, such as the Internet, catalog sales or in supermarkets, those rights should be specifically reserved.<sup>2</sup> If the franchisor desires the right to operate or license others to operate a franchised business in non-traditional venues, such as airports, casinos, military bases, sports arenas or similar venues, those rights should be specifically reserved. Franchisors have learned that their reserved rights should be specific and complete in order to

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<sup>2</sup> *Carvel Corp. v. Baker*, 79 F. Supp. 2d 53 (D. Conn. 1997).

refute any claim by a franchisee that such expansion right cannot be determined by implication from the limited territorial protection granted to the franchisee. Before *Scheck v. Burger King Corp.*<sup>3</sup>, franchisors generally considered that all rights for expansion and development of other businesses were retained by the franchisor except those specifically granted to the franchisee. *Scheck* permitted a claim of violation of the implied covenant of good faith and fair dealing in connection with expansion of the franchised business to the possible detriment of an existing franchisee. Although not all courts have followed *Scheck*<sup>4</sup>, in order to avoid any claim or question about the rights of the franchisor and to define clearly the expectations of their franchisees, prudent franchisors include explicit reservation of rights in the franchise agreement whether or not any territorial protection is granted to the franchisee.<sup>5</sup>

## **B. What is an Example of an Overly Complicated Provision?**

*Upon the execution of this Agreement, Franchisee will be assigned the primary area of responsibility (the "Primary Area of Responsibility" or "PAR") described in Attachment \_\_\_ and attached hereto. Except as provided in this Agreement, and subject to Franchisee's and the Controlling Principals' full compliance with this Agreement, any other agreement among Franchisee or any of its affiliates (defined as any entity that is controlled by, controlling or under common control with such other entity) and Franchisor or any of its affiliates, neither Franchisor nor any affiliate shall establish or authorize any other person or entity, other than Franchisee, to establish a Restaurant in the Primary Area of Responsibility during the term of this Agreement.*

*Notwithstanding the generality of the foregoing section, Franchisor retains all other rights, and therefore Franchisor shall have the right (among others) on any terms and conditions Franchisor deems advisable, and without granting Franchisee any rights therein, to:*

*1. Establish, and license others to establish, Restaurants and otherwise sell the food and beverage Products under the Marks at any location outside the Primary Area of Responsibility;*

*2. Establish, and license others to establish, Restaurants and otherwise sell food and beverage Products under the Marks in a Reserved Area (as defined below) at any location within or outside of the Primary Area of Responsibility. As used in this Agreement, a "Reserved Area" is defined as all airports, sporting arenas, stadiums, and United States Department of Defense locations, military installations and other federal government agencies (including, without limitation, Navy, Marine Corp, Army and Air Force bases and exchange service facilities); provided, however, the Franchisor agrees that (i) Franchisee may pursue, on a non-exclusive basis, any and all opportunities to operate a Restaurant in an airport, sporting arena, or stadium located within the geographic borders of the PAR, and (ii) in the event that Franchisee has secured all necessary permits and approvals from the necessary authorities to operate a Restaurant in an airport, sporting arena, or stadium, as applicable, located within the geographic borders of the PAR, Franchisor may approve of such location on the same terms and conditions as it would for a location outside of a Reserved Area. The parties hereto agree*

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<sup>3</sup> *Scheck v. Burger King Corp.*, 756 F. Supp. 543 (S.D. Fla. 1991).

<sup>4</sup> See, e.g., *Burger King Corp. v. Weaver*, 169 F.3d 1310 (11<sup>th</sup> Cir. 1999).

<sup>5</sup> For additional information on encroachment and the implied covenant of good faith and fair dealing and the developments in the case law after *Scheck*, see Dady, J. M. et al. *Franchise Agreements: How Complicated Do They Need to Be?*, ABA Forum on Franchising (2007).



*that nothing this Section shall in any way limit the Franchisor's right to operate, or license another party to operate, a Restaurant in a Reserved Area; and*

**3.** *Sell and distributed directly or indirectly, or license others to sell and distribute, directly or indirectly, any collateral products under the Marks (e.g., pre-packaged food and beverage Products and Restaurant memorabilia) from any location to any purchaser by any method or channel of distribution (including, without limitation, the Internet, mail order, and/or retail locations whether located within or outside of the PAR), so long as such sales are not conducted from a Restaurant operated from a location inside the PAR.*

#### **AREA OF RESPONSIBILITY:**

*Pursuant to Section X of the Franchise Agreement, the Primary Area of Responsibility shall be the contiguous property controlled by the landlord within which the Restaurant is located, if applicable. If the Restaurant is not located within such a contiguous property, the Primary Area of Responsibility is limited to the approved location described above.*

#### **C. Does the Example of an Overly Complicated Provision Accomplish the Purpose for Which it was Intended?**

The above example of a territorial protection provision and reservation of rights appears to apply the concept of a "Primary Area of Responsibility" which is generally more appropriate for a franchised business that is not location-specific. The agreement references the specific approved location and the grant of the license is for that location only. It then provides that the Primary Area of Responsibility will be the protected territory but the description of the Primary Area of Responsibility is very limited: contiguous property owned by a landlord (shopping center or shopping mall perhaps). If the restaurant is not located in any contiguous property, then there really is not any protected territory at all.

If the franchisor desired to provide a meaningful territorial protection to the franchisee for its restaurant, it could have done so in a simpler fashion based on particular street boundaries in an urban setting, or a certain radius distance around the approved location, and it could have attached a map to avoid any ambiguity.

The franchisor is also requiring "full compliance" with the franchise agreement and all other agreements between the franchisee and its affiliates and the franchisor and its affiliates. What does this mean and how does this work? If the franchisor considers that the franchisee is not in full compliance, is it then able to grant a franchise for a restaurant within the described area? What if there is a dispute over the meaning of "full compliance"? What if the franchisee is not in full compliance at the time of the additional grant but then remedies the default and is in full compliance by the time the additional restaurant is ready to open? These issues need to be addressed in the agreement if the franchisor considers that such a limitation on the territorial protection is warranted, given the relationship it is attempting to establish with the franchisee.

The franchisor retains the rights to establish and grant others the right to establish restaurants outside of the Primary Area of Responsibility, but does not include the possibility of other brands or business activities the franchisor may develop in the future.

The franchisor specifically reserves special rights as to the "Reserved Areas" which means airports, stadiums, sporting arenas and Department of Defense locations, military installations and other federal government agencies that are located within the Primary Area of

Responsibility. Given the definition of the Primary Area of Responsibility, it seems impossible that such Reserved Areas could exist. Even if the Primary Area of Responsibility were defined as a larger geographic area, the provision is confusing. It includes an exception for the franchisee, but only for stadiums, sporting arenas and airports (no military or federal agency locations) and the franchisor still must approve that new restaurant location.

Finally, the franchisor does provide for the possibility of selling collateral products, such as, pre-packaged food and memorabilia under the trademarks from any location and by any means (such as Internet, mail order or other retail locations) as long as they are not sold from a restaurant within the Primary Area of Responsibility. If the Primary Area of Responsibility is the territory granted to the franchisee, then that condition to the reservation does not seem logical. At most, it would restrict the franchisor from selling products through other restaurants located on contiguous property owned by the franchisee's landlord.

**D. What is an Example of a Simpler Provision?**

*Neither Franchisor nor any affiliate will establish or authorize the opening of a Restaurant within the X mile radius (the "Restricted Territory") of the Restaurant for a period of X years after the date of this Agreement. The restrictions set forth in this Section will not apply to any Restaurants already existing or under development in the Restricted Territory as of the date of this Agreement or any other brands licensed by Franchisor or its affiliates other than the Restaurant brand, or if any Restaurant ceases to operate as a Restaurant, then for each such restaurant, an additional restaurant may operate as a Restaurant.*

*Franchisee agrees except as set forth above that Franchisor reserves the right at any location outside of the Restricted Territory to establish or license others to establish a Restaurant, and any other business operations and Franchisor may exercise such right without notice to Franchisee.*

*Within the Restricted Territory, Franchisor retains the right to establish or license others to establish a Restaurant in any airports, sporting arenas and stadiums but during the term of this Agreement, Franchisor will offer Franchisee the first opportunity to obtain a franchise for a Restaurant in any such venues if Franchisee and its Affiliates are in compliance with all material provisions of its agreements with Franchisor and its Affiliates. Franchisor retains the right to establish or license others to establish a Restaurant in any U.S. military locations or federal government locations within the Restricted Territory, and Franchisee will have no opportunity to obtain a franchise for any such Restaurant.*

*Franchisor retains the right to sell products and services authorized for the Restaurant under other trademarks and service marks and commercial symbols through any channels of distribution Franchisor deems appropriate.*

**E. Does the Example of a Simpler Provision Accomplish the Purpose for Which it was Intended?**

This provision makes clear that the timing of the protected territory—it begins on the date the franchise agreement is executed (even if it may take the franchisee several months to build and equip the restaurant) and expires on a set anniversary date of the franchise agreement, making it easy for franchisor's development personnel to track the territorial protection and identify for its planning purposes when the territory will be "open" for possible additional development of other restaurants.

Additionally, the provision provides flexibility for the franchisor. It permits the franchisor to consider the development or acquisition of other brands or businesses with the assurance that it will not have to consider its contractual rights and obligations under the franchise agreements with its existing franchisees.

The provision also provides a meaningful territory to the franchisee instead of a Primary Area of Responsibility that is limited to the approved location for the restaurant or a contiguous property the landlord may own. For a restaurant, the protection desired should be a specific geographical area surrounding the restaurant so that the franchisee can have the comfort of knowing that the franchisor will not be establishing or granting a license for a third party to develop and operate the same branded restaurant that would attract the same customers until the franchisee has at least had some time to establish its clientele.

While some sophisticated franchise systems have developed growth policies and established means to notify existing franchisees if there is consideration of the grant of additional franchises in existing markets, the provision does not require such notification or the creation of any such policies or procedures by the franchisor.

To the extent that there are desired exceptions to the territorial grant, those must be specifically described. The simpler provision addresses other channels of distribution for restaurant related food or other branded items and the rights of the franchisor to make those sales. It also permits the franchisor to control the expansion of the branded restaurants in those particularly described locations (airports, stadiums, sporting arenas) even if they are located within the protected territory.

### **III. PRODUCT AND SERVICE SOURCING**

#### **A. What is the Purpose of the Provision?**

The products and services that a franchisee offers are crucial to the success of a concept. The appeal of a franchise concept to the customer is the assurance of receiving a consistent experience no matter what location the customer patronizes. If a customer does not receive the expected level of quality, taste or experience to which he or she is accustomed, brand loyalty is affected. Therefore, it is important for a franchisor to provide restrictions on types and quality of products and services as well as on the qualifications of suppliers who provide products to franchisees. Proprietary products are essential to some franchise systems and merit the strictest requirements. Therefore, the supplier must frequently be the franchisor or its affiliate or a particular supplier designated by the franchisor.<sup>6</sup>

In addition, a franchisor may have an agreement it has negotiated with a supplier for the entire chain, such as a pouring agreement when the franchised business involves food service. This agreement may require joint advertising with the franchised system, resulting in promotion of both brands. Moreover, this type of system-wide agreement can result in benefits to both franchisors and franchisees: additional advertising, attractive pricing, increased revenues and

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<sup>6</sup> A drafter must be familiar with the antitrust issues raised by these provisions, but they are beyond the scope of this program. See, e.g., Cantor, A. & Klarfeld, P., "An Unheralded State Through the Heart of *Siegel v. Chicken Delight* and a New Climate for Franchise Tying Claims," *Franchise Law Journal*, Vol., 28, Issue 1 (2008) and Feirman, S. & Hillman, A., *Antitrust Issues: Back in Vogue*, ABA Forum on Franchising (2010).

the possibility of rebates and other incentives.<sup>7</sup> Alternatively, the franchisor may incorporate certain equipment into its system manufactured by a particular supplier. Both of these situations call for a provision requiring the franchisee to purchase designated brand-name supplies or equipment.

**B. What is an Example of an Overly Complicated Provision?**

**1. Food Products and Supplies**

*Franchisor requires that proprietary and perishable products, as same are designated from time to time in writing by Franchisor, be purchased exclusively from Franchisor or Franchisor's designated supplier(s). Franchisee shall cause the Restaurant to conform to Franchisor's specifications and quality standards, and shall purchase only from distributors and suppliers approved by Franchisor all other food products, beverages, ingredients, flavorings, and garnishes and all beverages, cartons, bags, boxes, napkins, other containers, paper and plastic goods, packaging supplies, and other materials. In approving such distributors and suppliers, Franchisor may consider such factors as quality of delivery service, inventory capability, financial condition, price and the reliability of the distributor or supplier. If the item to be supplied will bear one of the Franchisor's trademarks, the parties acknowledge that Franchisor may require the supplier to pay a license fee to Franchisor. Franchisor may arrange for the concentration of purchases with one or more distributors or suppliers to obtain competitive prices and/or the best advertising support and/or services for any group of restaurants franchised or operated by Franchisor or an affiliate. Approval of a distributor or supplier may be conditioned on requirements relating to the frequency of delivery, standards of service, including prompt attention to complaints, and concentration of purchases, as set forth above, may be temporary, pending a further evaluation of the distributor or supplier by Franchisor, and may be changed from time to time. Franchisor reserves the right at its discretion to develop additional proprietary items, including promotional materials, signs, menus, etc., that may be available only from Franchisor. If Franchisor arranges for, or establishes, a cooperative buying program, so as to maintain the high quality for the products associated with the System, Franchisor may require that Franchisee join, actively participate in, and make all purchases/leases solely through, the purchasing cooperative or other entity designated by Franchisor (the "Co-op"). Franchisee must promptly pay all amounts due any such entity for purchases/leases, dues or otherwise. The Co-op may adopt its own bylaws, rules, regulations and procedures, which Franchisee must follow, but the bylaws, rules, regulations and procedures of such Co-op are subject to consent by Franchisor in its business judgment. If the Co-op cannot reach agreement on any point, Franchisor will make the relevant decision, which will be binding on Franchisee. Franchisee's failure to timely pay amounts due to, or comply with the bylaws, rules, regulations and procedures of the Co-op constitutes a material breach of the provisions of this Agreement. Franchisor may offset against amounts Franchisor owes to Franchisee the amount of Franchisee's unpaid Co-op obligations. Franchisor can require the Co-op to submit monthly and annual financial statements, and can require that the annual financial statements be audited, all at the expense of the Co-op. Franchisor may from time to time require Franchisee to discontinue the use or sale of any product or item, or disapprove a previously approved distributor or supplier which or who in Franchisor's opinion does not meet the standards of quality established by Franchisor.*

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<sup>7</sup> See Dady, J.M. et al., *Franchise Agreements: How Complicated Do they Need to Be?*, ABA Forum on Franchising (2007) for a detailed discussion in vendor rebates.

## **2. Franchisee's Proposed Suppliers**

a. Franchisor may, in its sole discretion, approve suppliers proposed by Franchisee provided the following conditions are first met:

i. Franchisee shall submit a written request to Franchisor for approval of the supplier and agree to pay Franchisor's expenses in evaluating the proposed supplier;

ii. The supplier shall demonstrate to Franchisor's satisfaction that it is able to supply an item to Franchisee meeting Franchisor's specifications for such item, including but not limited to, providing Franchisor with samples and the opportunity to inspect its facilities from time to time;

iii. The supplier shall demonstrate to Franchisor's satisfaction that the supplier is of good standing in the business community with respect to its financial soundness and the reliability of its product and service;

iv. The supplier shall obtain, maintain and submit to Franchisor proof of, sufficient insurance coverage (including, but not limited to, product liability coverage) at limits and including coverage acceptable to Franchisor, and include Franchisor and Franchisee as additional named insureds with the right to receive at least thirty (30) days' prior written notice of any modification, cancellation or termination of such policy; and

v. In the event the item to be supplied is required to bear one of the Franchisor's trademarks, such supplier must execute a license agreement (which may include a royalty payment) in a form acceptable to Franchisor.

## **3. Suppliers of Paper and Plastic Goods and Containers**

Franchisee may purchase all printed paper, paper products, plastic goods and containers from any source, provided the supplier meets the standards established from time to time by Franchisor and provided the items to be purchased are in strict accordance with the standards and specifications of Franchisor; bear Franchisor's trademarks and text required by Franchisor; and are purchased by Franchisee.

## **4. Franchisor's Suggested Suppliers**

If Franchisor suggests suppliers or manufacturers of supplies to Franchisee, it does so only as an accommodation to Franchisee, and Franchisee shall not be obligated to purchase such items from such sources, so long as Franchisee maintains the required quality and conforms with Franchisor's standards and requirements. Notwithstanding the foregoing, Franchisor shall have the right to designate by brand name the equipment, including, without limitation, ovens, refrigeration, fountain and dispensing equipment, cash registers and all other mechanical equipment, that Franchisee shall use in the Restaurant. Franchisee shall use only such equipment as Franchisor has previously designated or approved in writing.

## **5. Designated Equipment, Services and/or Suppliers**

Franchisee will purchase, use and offer each of, and only, such types, brands and/or quality of designated equipment, products and services as Franchisor designates and, where

*Franchisor so requires, use only suppliers as designated by Franchisor. Such suppliers may include, and may be limited to Franchisor and/or companies affiliated with Franchisor. Franchisor may designate a single supplier or limited number of suppliers, may designate a supplier only as to certain items and may concentrate purchases with one or more suppliers in our business judgment. Specification of a supplier may be conditioned on requirements relating to frequency of delivery, standards of service, including prompt attention to complaints, as well as payments, contributions or other consideration to Franchisor, its affiliates, the marketing fund and/or otherwise, and may be temporary, in each case in our business judgment. Franchisor may, from time-to-time, withhold, condition and/or revoke Franchisor's approval of particular items or suppliers in Franchisor's business judgment. Franchisor notifies Franchisee in writing (and submit to Franchisor such information and samples as Franchisor requests) if Franchisee proposes to purchase, use or offer any type, brand and/or quality of items that has not been previously specified by Franchisor, or if Franchisee proposes to use any supplier who has not been previously specified by Franchisor for the proposed item. Franchisor shall notify Franchisee within a reasonable time whether or not Franchisee is authorized to purchase or use the proposed item or to deal with the proposed supplier. Franchisee will not make any claims against Franchisor with respect to any supplier (and/or our designation and/or supervision of, our relationship with, such supplier or otherwise), and will make any claims with respect to any supplier-related and/or similar matters only against the supplier in question. Franchisee will not take any legal or other action against or with respect to any vendors without Franchisor's prior written consent, which Franchisor may grant, condition or deny in Franchisor's business judgment.*

**C. Does the Example of an Overly Complicated Provision Accomplish the Purpose for Which it was Intended?**

The provision does not clearly distinguish between the product and service requirements imposed on the franchisee. Distinguishing products that are proprietary to the franchise system and identifying restrictions as an integral part of that system would help to bolster the enforceability of the restriction.

Although the provision details a number of conditions in the franchisor's decision whether or not to approve a supplier proposed by the franchisee, the franchisor runs the risk of being limited to those conditions in making its decision. Subsection 2 permits the franchisee to propose suppliers for non-proprietary products. Many franchise agreements include lists of criteria that the franchisor may consider in deciding whether or not to approve a supplier. It is crucial not to create a duty on the part of the franchisor to apply these criteria to each proposed supplier, but rather to leave that to the franchisor's discretion. If the provision is ambiguous, a court may apply the implied covenant of good faith and fair dealing to interpret the intent of the parties.<sup>8</sup>

Finally, the provision, as detailed as it is, does not address the issue of vendor rebates to the franchisor as a result of franchisees' purchases, a key source of franchisee complaints.

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<sup>8</sup> See *DavCo Acquisition Holding, Inc. v. Wendy's Int'l, Inc.*, No. 2:07-cv-1064, 2008 U.S. Dist. LEXIS 27108 (S.D. Ohio Mar. 19, 2008).

**D. What is an Example of a Simpler Provision?**

**1. Products and Services**

*Franchisee will offer to customers all products and services, and only those products and services, designated by Franchisor from time to time, and will provide such products and services strictly in accordance with the standards and specifications described in the Manual.*

**2. Purchase of Products; Approved Suppliers**

**a.** *Franchisee will purchase all logo merchandise and all other materials or equipment required or used in the operation of the Franchised Business only from (a) manufacturers, suppliers or distributors from time to time designated in writing by Franchisor, (b) such other suppliers selected by Franchisee and approved by Franchisor as set forth in subsection b; or (c) from Franchisor or its affiliate, if available. Franchisee acknowledges that certain specially designed equipment, proprietary products, certain services and items used in the Franchised Business that are integral to the System may only be available from Franchisor or its designated supplier.*

**b.** *Franchisee may propose a supplier for non-proprietary products or services by submitting a written request to Franchisor. Such request must include all information required for Franchisor to evaluate the supplier including samples of the item for which approval is requested, and other information required by the Operations Manual. Franchisor will determine whether or not to consent to the supplier, in Franchisor's sole discretion. Nothing herein will be construed to require that Franchisor approve any particular supplier.*

**c.** *Until and unless Franchisor notifies Franchisee in writing that it has approved a supplier, Franchisee must continue to purchase from the parties described in subsection 1.*

**d.** *If Franchisor determines that a previously approved supplier no longer conforms to such standards, it will so notify Franchisee and Franchisee shall thereupon discontinue making purchases from that supplier.*

**e.** *Franchisor and its affiliate have the right to receive payments from suppliers on account of suppliers' dealings with Franchisee and other franchisees and may use all amounts so received without restrictions. Franchisor is not obligated to pass on any supplier payments to Franchisee.*

**3. Designated Brand-Name Supplies and Equipment**

*Franchisor will have the right to designate by brand name the supplies and equipment that Franchisee is required to use in the Franchised Business.*

**E. Does the Example of a Simpler Provision Accomplish the Purpose for Which it was Intended?**

The simpler provision is concise but is much clearer in the manner in which it describes the franchisee's obligations. By referencing the operations manual it can omit cumbersome language that is better included there because of the frequency of change during the term of the

franchise agreement. The last sentence in Subsection 2b is important because it states explicitly that the franchisor has the unilateral authority to approve or disapprove suppliers, thus providing no basis to infer a covenant of good faith and fair dealing.<sup>9</sup> In addition, the simpler provision makes a clearer distinction between proprietary and non-proprietary products, thus enhancing the ability of the franchisor to enforce the requirements, if necessary.

Finally, the provision addresses the issue of payments from vendors and suppliers to the franchisor. As the franchise system evolves, these payments and the manner in which the franchisor treats them can become an important tool for system growth or a major bone of contention with franchisees. Preserving maximum flexibility is important because the franchisor may not yet know the extent of rebates, whether the vendor will require that they be spent in any particular manner or if it will be necessary to use them to support a particular sector of the system. This is an area of contention in certain franchise systems and it behooves the franchisor to be explicit in both the franchise agreement and disclosure document. The language in Subsection 2e was analyzed by at least one court and found sufficient.<sup>10</sup>

As to the style, the provision uses the term "including" to give examples, but eliminates the common words that often follow: "without limitation" or "but not limited to" based on a catch-all provision found elsewhere in the agreement that specifically provides that all references to "includes" and "including" are illustrative and not exhaustive.

#### **IV. DEFAULT AND TERMINATION**

##### **A. What is the Purpose of the Provision?**

Default and termination sections of the franchise agreement are crucial. They are one of the keys to the franchisor's ability to enforce system standards. They are also important to franchisees in compliance with their obligations under their franchise agreements because they know the franchisor will be able to maintain a strong, well-performing system by enforcing the requirements of the system.

A number of states have franchise relationship laws that can affect the enforceability of default and termination provisions in a franchise agreement.<sup>11</sup> Most require good cause. The franchise agreement can be an important tool in defining what constitutes good cause under particular circumstances and in particular industries. Drafting a default and termination provision that accounts for common provisions of relationship laws can increase the franchisor's ability to enforce a termination.<sup>12</sup> Failure to account for the provisions of franchise relationship laws can create unrealistic expectations on the part of both franchisors and franchisees.

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<sup>9</sup> *Id.*

<sup>10</sup> *Westfield v. Quizno's Franchise Co.*, 527 F. Supp.2d 840 (E.D. Wis. 2007), *vacated in part*, No. 06-C-1210, 2008 U.S. Dist. LEXIS 74398 (E.D. Wis. Apr. 16, 2008).

<sup>11</sup> See, e.g., Cal. Bus. & Prof. Code § 20020; Haw. Rev. Stat. § 482E-6(2)(H); Wash. Rev. Code. Ann. § 19.100.180(2)(j).

<sup>12</sup> See, e.g., *Open Pantry Food Marts of Wis. v. Garcia's Five, Inc.* CCH Bus. Franchise Guide ¶ 8113 (Wis. Cir. Ct. 1984) (granting plaintiff's motion to appoint a receiver and denying defendant's motion for a temporary injunction because termination for insolvency or the imminent threat of insolvency was statutorily recognized by Wisconsin law).



**B. What is an Example of an Overly Complicated Provision?**

1. Franchisee acknowledges and agrees that (i) each of Franchisee's obligations described in this Agreement is a material and essential obligation of Franchisee, (ii) non-performance of such obligations will adversely and substantially affect the Franchisor and the System, and (iii) the exercise by Franchisor of the rights and remedies set forth herein is appropriate and reasonable.

2. Franchisee shall be deemed to be in default under this Agreement, and all rights granted herein shall automatically terminate without notice to Franchisee, if Franchisee or any controlling shareholder if Franchisee is a corporation, or a partner if Franchisee is a partnership, or managing member if Franchisee is a limited liability company (i) shall become insolvent or makes a general assignment for the benefit of creditors, or (ii) files a voluntary petition under any section or chapter of federal bankruptcy law or under any similar law or statute of the United States or any state thereof, or admits in writing its inability to pay its debts when due, or (iii) if an involuntary petition in bankruptcy is filed against Franchisee or a controlling shareholder if Franchisee is a corporation, or a partner if Franchisee is a partnership, or managing member if Franchisee is a limited liability company and not dissolved, withdrawn or dismissed within sixty (60) days after filing; or (iv) is adjudicated bankrupt or insolvent in proceedings filed against Franchisee under any section or chapter of federal bankruptcy laws or under any similar law or statute of the United States or any state, or (v) is the subject of any bill in equity or other proceeding for the appointment of a receiver or other custodian (permanent or temporary) for the business or assets of Franchisee or the controlling shareholder if Franchisee is a corporation, or a partner if Franchisee is a partnership, or managing member if Franchisee is a limited liability company, or (vi) has its assets or property, or any part thereof, appointed to a receiver or other custodian (permanent or temporary) by any court of competent jurisdiction, (vii) has filed or instituted against it any proceedings for a composition with creditors under any state or federal law, or (viii) is subject to a final judgment which remains unsatisfied or of record for sixty (60) days or longer (unless a supersedes or other appeal bond is filed), (ix) is dissolved, (x) has an execution levied against its business or property, the license granted by this Agreement or upon any property used in the Restaurant, and same is not discharged within five (5) days of such levy or execution, (xi) is the subject of any suit to foreclose any lien or mortgage against the Restaurant premises or equipment (and such suit or lien is not dismissed within sixty (60) days), or (xii) if the real or personal property of Franchisee's Restaurant is seized, taken over, or foreclosed by a government official in the exercise of his duties, or seized, taken over, or foreclosed by a creditor, lienholder, or lessor. Franchisee expressly and knowingly waives any rights that Franchisee may have under any bankruptcy act to assume this Agreement, and this Agreement shall be deemed rejected upon the occurrence of this event of default. Franchisee agrees not to seek any injunctive order from any court in any insolvency proceeding which would have the effect of staying or enjoining this provision and agrees not to oppose any relief which may be sought in a complaint by Franchisor to lift the provisions of the automatic stay of the bankruptcy rules.

3. Franchises shall be deemed to be in material default and Franchisor may, at its option, terminate this Agreement and all rights granted hereunder, without affording Franchisee any opportunity to cure the default, (except as stated below or otherwise required by law), effective immediately upon notice to Franchisee, upon the occurrence of any of the following events:

**a.** *If Franchisee operates the Restaurant or sells any products or services authorized by Franchisor for sale at the Restaurant at a location which has not been approved by Franchisor;*

**b.** *If Franchisee fails to acquire an Approved Location for the Restaurant within the time and in the manner specified in Section X;*

**c.** *If Franchisee fails to construct or remodel the Restaurant in accordance with the plans and specifications provided to Franchisee under Section X as such plans may be adapted with Franchisor's approval in accordance with Section X;*

**d.** *If Franchisee fails to open the Restaurant for business within the period specified in Section X hereof;*

**e.** *If Franchisee at any time abandons the Restaurant by failing to operate the Restaurant for five (5) consecutive days during which Franchisee is required to operate the Restaurant under the terms of this Agreement, or any shorter period, after which it is not unreasonable under the facts and circumstances for Franchisor to conclude that Franchisee does not intend to continue to operate the Restaurant, or loses the right to possession of the premises, or otherwise forfeits the right to do or transact business in the jurisdiction where the Restaurant is located; provided, however, that this provision shall not apply in cases of Force Majeure (acts of God, strikes, lockouts or other industrial disturbances, war, riot, epidemic, fire or other catastrophe or other forces beyond Franchisee's control), if through no fault of Franchisee, the premises are damaged or destroyed by an event as described above, provided that Franchisee applies within thirty (30) days after such event, for Franchisor's approval to relocate or reconstruct the premises (which approval shall not be unreasonably withheld) and Franchisee diligently pursues such reconstruction or relocation; such approval may be conditioned upon the payment of an agreed minimum fee to Franchisor during the period in which the Restaurant is not in operation;*

**f.** *If Franchisee or any controlling shareholder if Franchisee is a corporation, or a partner if Franchisee is a partnership, or managing member if Franchisee is a limited liability company, is convicted of, or has entered a plea of nolo contendere to, a felony, a crime involving moral turpitude, that Franchisor reasonably believes is likely to have an adverse effect on the System, the Marks, the goodwill associated therewith, or Franchisor's interests therein;*

**g.** *If a threat or danger to public health or safety, as determined in writing by a governmental agency having jurisdiction over such matters, results from the construction, maintenance or operation of the Restaurant, and such public health or safety concern remains uncured for ten (10) days following Franchisee's actual or constructive knowledge;*

**h.** *If Franchisee fails to propose a qualified replacement or successor controlling shareholder if Franchisee is a corporation, or a partner if Franchisee is a partnership, or managing member if Franchisee is a limited liability company, within the time required under Section X hereof;*

**i.** *If Franchisee or any controlling shareholder if Franchisee is a corporation, or a partner if Franchisee is a partnership, or managing member if Franchisee is a limited liability company, purports to transfer any rights or obligations under this Agreement or*

*any interest in Franchisee or the Restaurant to any third party without Franchisor's prior written consent or without offering Franchisor a right of first refusal with respect to such transfer, contrary to the terms of Section X of this Agreement;*

*j. If Franchisee or any of its affiliates fails, refuses, or neglects promptly to pay any monies owing to Franchisor, or any of its affiliates or vendors, or any taxing authority for federal, state or local taxes (other than amounts being bona fide disputed through appropriate proceedings) when due under this Agreement or any other agreement, or to submit the financial or other information required by Franchisor under this Agreement and does not cure such default within five (5) days following notice from Franchisor (or such other cure period specified in such other agreement, unless no cure period is stated or such period is less than five (5) days, in which case the five (5) day cure period shall apply).*

*k. If Franchisee or any controlling shareholder if Franchisee is a corporation, or a partner if Franchisee is a partnership, or managing member if Franchisee is a limited liability company, fails to comply with the in-term covenants in Section X hereof or Franchisee fails to obtain execution of the covenants and related agreements required under Section X hereof within thirty (30) days following notice from the Franchisor;*

*l. If, contrary to the terms of Section X hereof, Franchisee or any controlling shareholder if Franchisee is a corporation, or a partner if Franchisee is a partnership, or managing member if Franchisee is a limited liability company, discloses or divulges any confidential information provided to Franchisee or the controlling shareholder if Franchisee is a corporation, or a partner if Franchisee is a partnership, or managing member if Franchisee is a limited liability company, by Franchisor, or fails to obtain execution of covenants and related agreements required under Section X hereof within thirty (30) days following notice from the Franchisor;*

*m. If a transfer upon death or permanent disability is not transferred in accordance with Section X and within the time periods therein;*

*n. If Franchisee knowingly maintains false books or records, or submits any false reports to Franchisor;*

*o. If Franchisee breaches in any material respect any of the covenants in any material respect set forth in Section X or has falsely made any of the representations or warranties set forth in Section X;*

*p. If Franchisee fails to propose a qualified replacement or successor controlling shareholder if Franchisee is a corporation, or a partner if Franchisee is a partnership, or managing member if Franchisee is a limited liability company or general manager within the time required under Sections X and X, respectively following ten (10) days prior written notice;*

*q. If Franchisee fails to procure and maintain such insurance policies as required by Section X and Franchisee fails to cure such default within ten (10) days following notice from Franchisor;*

*r. If Franchisee misuses or makes any unauthorized use of the Marks or otherwise materially impairs the goodwill associated therewith or Franchisor's rights therein; provided that, notwithstanding the above, Franchisee shall be entitled to notice of such event of default and shall have twenty-four (24) hours to cure such default;*

**s.** *If Franchisee or any controlling shareholder if Franchisee is a corporation, or a partner if Franchisee is a partnership, or managing member if Franchisee is a limited liability company, on two (2) or more separate occasions within any period of twelve (12) consecutive months, or on three (3) or more separate occasions within any period of twenty-four (24) consecutive months, in any obligation including, but not limited to, any failure by Franchisee or any controlling shareholder if Franchisee is a corporation, or a partner if Franchisee is a partnership, or managing member if Franchisee is a limited liability company. to timely submit any reports required by Franchisor, or to make any payments through Franchisor's electronic funds transfer system), whether the same or different, whether under this Agreement, any other agreement with Franchisor and/or any of Franchisor's affiliates, the Manuals or otherwise, whether or not such defaults are timely corrected. If Franchisee (and/or any controlling shareholder if Franchisee is a corporation, or a partner if Franchisee is a partnership, or managing member if Franchisee is a limited liability company, has (a) defaulted, on two (2) or more separate occasions within any period of twelve (12) consecutive months, or on three (3) or more separate occasions within any period of twenty four (24) consecutive months, in any obligation(s) to Franchisor and/or any of the franchisor-related persons/entities (whether the same or different), whether or not such defaults are timely corrected, or (b) have committed any default, or have violated any obligation to Franchisor and/or any of the franchisor-related persons/entities, which is incurable or (c) have committed any default, or have violated any obligation to Franchisor and/or any of the franchisor-related persons/entities, which remains uncured after any applicable cure period, whether under this Agreement, any other agreement with Franchisor and/or any of Franchisor's affiliates, the Manuals or otherwise, then Franchisor may cancel any and/or all of Franchisee's territorial or similar rights (including, but not limited to, any rights-of-first-refusal), whether arising under this Agreement, any other agreement and/or otherwise;*

**t.** *If Franchisee or any of its affiliates fails or refuses to comply with any material terms and conditions of any sublease, or related agreement, between Franchisor or its affiliates and Franchisee or its affiliates, and does not cure such default within any notice and cure period provided for in such sublease or related agreement following notice from Franchisor of such default (unless no cure period is specified in the sublease or other agreement, in which case the notice and cure period provided in Section X, shall apply);*

**u.** *Franchisee or any of its owners' assets, property, or interests are blocked under any law, ordinance, or regulation relating to terrorist activities, or Franchisee or any of its owners otherwise violate any such law, ordinance, or regulation;*

**v.** *Franchisee makes any material misrepresentations relating to the acquisition of the franchise including (but not limited to) failure to disclose any prior litigation or criminal convictions (other than minor traffic offenses) or Franchisee engages in conduct which reflects materially and unfavorably upon the operation and reputation of the Restaurant or the System or Franchisor (including, but not limited to, child abuse or other mistreatment, health or safety hazards, drug or alcohol problems, or allowing unlawful activities or unauthorized or illegal items to be used or distributed at Franchisee's franchised location or in connection with the Franchise);*

**w.** *Franchisee receives a score of 85% or lower on any quality assurance form or report or fails to meet the then-current standard as of the date of the report for the operation of the Franchise, and does not take all actions deemed necessary by Franchisor to meet such then-current standards within ten (10) calendar days after written notice is delivered to Franchisee.*

4. Upon any material default by Franchisee which is susceptible of being cured, Franchisor may terminate this Agreement by giving written notice of termination stating the nature of such material default to Franchisee at least thirty (30) days prior to the effective date of termination, unless a shorter period is set forth in a specific subsection of Section X. However, Franchisee may avoid termination by immediately initiating a remedy to cure such default and curing it to Franchisor's reasonable satisfaction within the thirty (30) day period and by promptly providing proof thereof to Franchisor. If any such material default is not cured within the specified time, or such longer period as applicable law may require, this Agreement shall terminate without further notice to Franchisee effective immediately upon the expiration of the thirty (30) day period or such longer period as applicable law may require. Defaults which are susceptible of cure hereunder may include, but are not limited to, the following illustrative events:

a. If Franchisee fails to comply with any of the requirements imposed by this Agreement, as it may from time to time be amended or reasonably be supplemented by Franchisor, or fails to carry out the terms of this Agreement in good faith.

b. If Franchisee fails to maintain or observe any of the reasonable standards, specifications or procedures prescribed by Franchisor in this Agreement or otherwise in writing.

c. If Franchisee fails, refuses, or neglects to obtain Franchisor's prior written approval or consent as required by this Agreement.

5. If Franchisee or any controlling shareholder if Franchisee is a corporation, or a partner if Franchisee is a partnership, or managing member if Franchisee is a limited liability company (or any person or entity affiliated with or controlled by Franchisee or any controlling shareholder if Franchisee is a corporation, or a partner if Franchisee is a partnership, or managing member if Franchisee is a limited liability company) is determined by Franchisor to be either (i) repeatedly in material default for failure to comply with the requirements of any other franchise agreement, development agreement, or other agreement to which Franchisor (or an affiliate of Franchisor) is a party (collectively, and as each may be amended from time to time, "Other Agreements"), whether or not such material defaults are of the same or different nature and whether or not such defaults have been cured after notice by Franchisor, or (ii) in material default for failure to substantially comply with the requirements of any Other Agreement, Franchisor may terminate this Agreement by giving written notice of termination stating the nature of such material default to Franchisee at least thirty (30) days prior to the effective date of termination.

Any termination of this Agreement pursuant to this Section X shall constitute an event of default under each of the Other Agreements, and Franchisor expressly reserves all rights and remedies available at law or equity including, without limitation, the right to terminate all of the rights and obligations of any and/or all of the Other Agreements. No right or remedy which Franchisor may have (including termination) is exclusive of any other right or remedy provided under law or equity and Franchisor may pursue any additional rights and/or remedies available.

6. If Franchisor issues a notice of default, Franchisor will have the right, in addition to Franchisor's other rights and remedies, (but no obligation) to appoint a manager to operate Franchisee's Franchise until Franchisee has cured all defaults. All funds from the operation of the Franchise during the period of management by Franchisor will be kept in a separate fund and all expenses of the Franchise, including compensation, other costs and travel

and living expenses of Franchisor's appointed manager, shall be charged to Franchisee and may be paid out of such fund. In addition to all other amounts due Franchisor and/or any affiliate and/or supplier, Franchisor shall be paid Five Hundred Dollars (\$500.00) per day during such management period as a management fee. Operation of the Franchise during any such period shall be for and on behalf of Franchisee; provided that Franchisor shall only have a duty to utilize reasonable efforts in the operation of the Franchise and shall not be liable to Franchisee for any debts, losses or obligations incurred by the Franchise, or to any of Franchisee's creditors for any items purchased by the Franchise during any period in which it is managed by Franchisor. In the event that the fund maintained by Franchisor is insufficient to pay the expenses of the Franchise in a reasonable business-like manner, Franchisor shall so notify Franchisee and Franchisee shall, within five (5) business days, deposit in the fund such amounts as shall be required by Franchisor to attain a reasonable balance in the fund. The provisions of this Paragraph shall not restrict Franchisor's right to terminate this Agreement as herein provided or affect any of Franchisor's indemnity or other rights.

7. If Franchisor issues a notice of default, Franchisor and each of its affiliates will have the right, in addition to Franchisor's other rights and remedies, to discontinue selling and/or providing any goods and/or services to Franchisee until Franchisee has cured all defaults and Franchisor and/or its affiliates may cease providing such items to Franchisee or require Franchisee to pay C.O.D. (i.e., cash on delivery) by certified check until such time as you correct this problem.

8. Franchisee's ownership of the Franchise is controlled by the provisions of this Agreement and Franchisee will have no equity or other continuing interest in the Franchise, any goodwill associated with it or otherwise, or any right to compensation, return of amounts paid or otherwise, at the expiration and/or termination of the term of the Franchise.

9. Notwithstanding anything contained herein to the contrary, where Franchisor has the right to terminate this Agreement, Franchisor shall have the right, to be exercised in Franchisor's reasonable business judgment, to grant to Franchisee an extended period of time to cure the breach which gave rise to Franchisor's right to terminate, but in no event shall such extended cure period be less than thirty (30) days, nor more than six (6) months, from the last day of the cure period otherwise applicable to such breach. Franchisee acknowledges that Franchisor's election to grant such an extended cure period shall not operate as a waiver of any of Franchisor's rights hereunder and that, in consideration for and at the time of such an extension, Franchisee and each owner and/or controlling shareholder if Franchisee is a corporation, or a partner if Franchisee is a partnership, or managing member if Franchisee is a limited liability company, will execute a general release and if Franchisee fails to execute such a release, the grant of such an extension will, in itself, constitute such a release.

10. Franchisee and Franchisor understand that there might develop situations in which Franchisee and Franchisor have a legitimate difference of opinion as to whether or not Franchisee is in compliance with various non-financial, operations obligations of Franchisee relating to Franchisee's compliance with the System. Franchisee and Franchisor also agree that the input of other franchisees in such matters might be helpful to, but should not be binding on, each of Franchisor and Franchisee. Therefore, if Franchisor believes that Franchisee is not in compliance with Franchisee's obligations to follow the System in any non-financial, operational areas, Franchisor may submit such issue to a committee of the Franchisee Advisory Council for their review and evaluation and Franchisee and Franchisor will cooperate with such committee in their deliberations. Any decision of such committee will be purely advisory and not legally binding.

11. *If Franchisee shall fail to operate the Franchise in accordance with the Manual or other confidential material; shall fail to use products, ingredients and methods of operation which conform to the specifications and standards of Franchisor, shall sell products not approved by Franchisor, shall fail in any other way to maintain Franchisor's standards of quality, appearance and service in the operation of the Franchise; shall permit a threat or danger to the public health or safety to exist in connection with the construction, maintenance or operation of the Restaurant; shall violate any law or fail to pay any taxes when due; or shall commit any breach hereof which may cause substantial damage to Franchisor or may materially endanger or impair the Marks, the System, the goodwill associated therewith, or Franchisor's ownership thereof, then after written notice to Franchisee and failure by Franchisee to cure within fifteen (15) days, or with respect to a threat or danger to public health or safety, after written or oral notice, within one day, or less Franchisor shall have the right (but not the obligation), at its sole discretion, without prejudice to any other right or remedy contained in this Agreement or provided by law or equity (including any right of termination), to take such actions as Franchisor deems necessary to cure the default, including without limitation, to close the Franchise. The reasonable costs of all such actions shall be at the sole expense of Franchisee. Franchisee shall reimburse Franchisor for all such costs promptly upon demand therefor. The rights set forth in this Section are in addition to any other rights and remedies Franchisor may have pursuant to this Agreement, at law or in equity.*

**C. Does the Example of an Overly Complicated Provision Accomplish the Purpose for Which it was Intended?**

There are a number of potential problems in the sample of an overly complicated default and termination section. One is the frequent reference to materiality. While this might seem a fair approach, the concept is fraught with subjectivity. What is material to the franchisor may not be material to the franchisee, and vice-versa. Moreover, just because a default is not material, does not mean that the franchisor does not have the right to compel compliance. For example, failure to pay a \$5,000 royalty bill may not be a material default to a franchisor that receives aggregate monthly royalty fees in the millions of dollars. Nevertheless, if the franchisor is not permitted to exercise rights under the default and termination section, there may not be a way to require the franchisee to fulfill its obligations and pay.

Involving the Franchise Advisory Council in a dispute between the franchisor and franchisee is another potential issue. On the surface it may appear reasonable. Involving other franchisees, who are operating at the same level of distribution as the franchisee, might lead to "horizontal" action on anything from termination to setting prices for goods and services, implicating antitrust laws. Moreover, in a heated dispute in which other franchisees may themselves have the same interest as the franchisee, the Council may be motivated by self-interest to side with the franchisee, not necessarily for the benefit of the system, but for their own individual profit.

Constant references to the type of owner of a franchisee that is an entity are confusing, cumbersome and unnecessary, and can be addressed by the use of a defined term.

The provision references *force majeure* events in one instance and not in others. For example, a franchisee may be excused from abandonment in the event of an earthquake, but that will not excuse the franchisee's failure to open on time. It is advisable instead to provide for a general *force majeure* provision in the franchise agreement.

**D. What is an Example of a Simpler Provision?**

**1. Termination**

*The following provisions are in addition to any other rights Franchisor may have, all of which are expressly reserved. The exercise by Franchisor of any right is not an election of remedies.*

**a. With Notice and No Opportunity to Cure**

*This Agreement will immediately terminate on delivery of notice to Franchisee by Franchisor upon the occurrence of any of the following events, each of which is deemed to be an incurable breach of this Agreement and each of which is deemed to be “good cause.” If Franchisee:*

*i. becomes insolvent or admits in writing Franchisee’s inability to pay its debts as they mature, or makes an assignment for the benefit of creditors, files a petition under any bankruptcy act, receivership statute, or the like or if a petition is filed by a third party, or if an application for a receiver is made by anyone and the petition or application is not resolved favorably to Franchisee within 90 days;*

*ii. abandons the Franchised Business by failing to operate it for five consecutive business days or for any shorter period that Franchisor determines that Franchisee does not intend to continue operating the Franchised Business;*

*iii. has made any material misrepresentation or omission in the application for the Franchised Business or in any report that Franchisee submits to Franchisor;*

*iv. fails to obtain Franchisor’s consent to the location of the Franchised Business within 90 days after signing this Agreement;*

*v. or a Principal is convicted by a trial court of or pleads no contest to a felony or other crime or offense or engages in conduct that reflects materially and unfavorably upon the operation and reputation of Franchisor or the System;*

*vi. attempts to make or makes an unauthorized transfer under this Agreement;*

*vii. is a party to any other agreement with Franchisor or its affiliate that is terminated for Franchisee’s breach;*

*viii. is evicted by the lessor;*

*ix. makes any unauthorized use of the Marks or Trade Secrets or Trade Secrets including the Manual;*

*x. fails on three or more occasions to comply with this Agreement, whether or not such failures to comply are corrected after notice and whether or not such failures to comply relate to the same or different requirements of this Agreement;*



**xi.** *has the Franchised Business or its assets or premises seized by a government official, or by a creditor, lien holder or lessor or a writ or levy of execution issues against the franchise or Franchisee's goods;*

**xii.** *fails, for a period of three days after notification of noncompliance, to comply with any applicable law; including the Americans with Disabilities Act;*

**xiii.** *intentionally under-reports its Gross Revenues to Franchisor;*

**xiv.** *has an undischarged execution of levy on the Franchised Business;*

**xv.** *has entered against it a judgment of more than \$5,000.00 and such judgment remains unsatisfied (unless an appeal is filed or a supersedeas bond is secured) for a period of more than 30 days;*

**xvi.** *if Franchisor determines that continued operation of the Franchised Business by Franchisee will result in imminent danger to public health or safety; or*

**xvii.** *if the United States government designates Franchisee or any person mentioned in Section X hereof a Specially Designated National or Blocked Person.*

## **2. With Notice and Opportunity to Cure**

*This Agreement will terminate upon Franchisee's failure to cure any of the following, each of which is deemed to be "good cause":*

**a.** *noncompliance with any requirement in this Agreement not listed in Subsection A above within 30 days after notice is delivered to Franchisee; or*

**b.** *failure to make payments to Franchisor for any amounts due within five days after notice is delivered to Franchisee.*

## **3. Compliance with Local Law**

*If any law of any jurisdiction requires a greater notice of the termination than is required by this Agreement, the prior notice or other action required by such law shall be substituted for the notice, and this Agreement is extended for that period of time.*

## **E. Does the Example of a Simpler Provision Accomplish the Purpose for Which it was Intended?**

The simpler provision includes a reference to "good cause", an element of many franchise relationship laws. The provision purports to define what constitutes good cause in terms of the relationship between the franchisor and franchisee in this particular franchise system. That may or may not be enforceable, but at a minimum it evidences the parties' agreement on what they deem good cause to be. Many of the specific events of default are patterned on franchise relationship law provisions.<sup>13</sup> The provision also includes a reference to

<sup>13</sup> See, e.g., Cal. Bus. & Prof. Code § 20020; Haw. Rev. Stat. § 482E-6(2)(H); Wash. Rev. Code. Ann. § 19.100.180(2)(j).

anti-terrorism law prohibitions. Finally, there is a provision addressing longer notice periods contained in some laws. While those laws would apply whether or not the provision is included, including the reference gives the franchisor the opportunity to address what happens if longer notice is required. The provision allows for the extension of the term of the agreement to meet any such franchise relationship law requirements. The provision also serves to adjust the parties' expectations and reserve the right to challenge the application of any law.

## V. COVENANTS NOT TO COMPETE

### A. What is the Purpose of the Provision?

The purpose of a covenant not to compete is to prevent franchisees from selling products and/or services similar to the franchisor during the term of and after the expiration or termination of a franchise agreement. As a general rule, in-term covenants not to compete are held enforceable by courts, even when their terms are or seem unreasonable in other contexts.<sup>14</sup> Post-term covenants are a different matter. For example, in California a state statute of general applicability makes the vast majority of covenants not to compete invalid.<sup>15</sup> Some courts have applied a narrow-restraint exception to California's prohibition. In *Campbell v. Trustees of Leland Stanford Jr. University*<sup>16</sup>, the Ninth Circuit held that a non-competition agreement that did not completely restrain the individual from practicing his "profession, trade, or business" would be enforceable. However, in *Edwards v. Arthur Andersen LLP*<sup>17</sup>, the California Supreme Court made clear that noncompete agreements are invalid unless expressly permitted by statute. Rejecting the circuit court's reading of California precedent, the California Supreme Court effectively slammed the door on the general enforceability of non-competition agreements.<sup>18</sup>

Several other states have general statutory rules declaring as void covenants in restraint of trade.<sup>19</sup> However, statutes can be changed. For example, the Georgia Constitution established that covenants that restrain trade or otherwise stifle competition are unlawful.<sup>20</sup> In 2010, the people of Georgia voted to amend the Constitution paving the way for the enactment of the Georgia Restrictive Covenants Act.<sup>21</sup>

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<sup>14</sup> See Carden, D. & Klarfeld, P.J., "We Have To Live With It" – Tips from the Litigators' Perspective on Advanced Drafting, at 17, ABA Forum on Franchising (2005) (citing *Dayton Time Lock Serv., Inc. v. Silent Watchman Corp.*, 52 Cal. App. 3d 1 (Cal. App. 2nd Dist. 1975); *Deutschland Enters. v. Burger King Corp.*, 957 F.2d 449 (7th Cir. 1992)).

<sup>15</sup> Cal. Bus. & Prof. Code § 16600 *et seq.*

<sup>16</sup> *Campbell v. Bd. of Trustees*, 817 F.2d 499 (9th Cir. 1987).

<sup>17</sup> *Edwards v. Arthur Anderson, L.L.P.*, 44 Cal. 4th 937 (Cal. 2008).

<sup>18</sup> *Id.* at 949-50 ("[W]e are of the view that California courts have been clear in their expression that section 16600 represents a strong public policy of the state which should not be diluted by judicial fiat. . . . section 16600 is unambiguous, and if the Legislature intended the statute to apply only to restraints that were unreasonable or overbroad, it could have included language to that effect.").

<sup>19</sup> See, e.g., Neb. Rev. Stat. § 59-801 ("Every contract, combination in the form of trust or otherwise, or conspiracy in restraint of trade or commerce, within this state, is hereby declared to be illegal.").

<sup>20</sup> Ga. Const. Art. III, § 6, ¶ 15.

<sup>21</sup> O.C.G.A. § 13-8-50, *et seq.*

The enforceability of covenants not to compete is primarily a function of state law. Because most states disfavor covenants not to compete, they are generally enforceable only to the extent the covenants are reasonable in terms of duration, geographic limits and the scope of the prohibited competition. The more reasonable the restrictions, the more likely it is to be enforced. Accordingly, to accomplish the purpose of a covenant not to compete, perhaps more than any other provision in the franchise agreement, the drafter needs to understand and consider the enforceability of the specific provision within the applicable state law parameters. There are significant public policy implications when restraining another party's ability to compete in the marketplace. The serious state law overlay significantly affects the parties' choice of governing law. Lawyers for franchisors and franchisees are wise to review not only the chosen law (usually the franchisor's home state), but also the franchisee's home state if different. A franchisor will not be able to obtain the same level of protection in every state.

In states where post-term covenants not to compete are enforceable, court precedent usually establishes the guideposts for drafters seeking to draft enforceable covenants. However, due to the varying fact patterns, there is no bright-line answer. The best guidance is usually found by taking a sampling of decisions in similar contexts.<sup>22</sup>

In addition to knowing the applicable law regarding enforceability, knowing the target franchisee market can be important as well.<sup>23</sup> Consider a restaurant franchise. It is probably not reasonable for a restaurant franchisor to expect that all franchisees, including large publicly traded companies and multi-unit operators, will have no interests in other restaurant businesses.<sup>24</sup> Not all restaurants are truly competitive with each other and the failure to narrowly define may keep some desirable franchisees at bay.<sup>25</sup> Finally, some consideration should be paid to the persons restricted by the covenant not to compete. The covenant can focus on the franchisee alone, or it can expand to include family members and other related parties. This decision depends on the level of involvement in the franchised business of these other parties.

## **B. What is an Example of an Overly Complicated Provision?**

### **Exclusive Relationship, Restrictions on Similar Business During Franchise Term and After Transfer, Termination, Expiration, Repurchase, Etc.**

*You and we share a mutual interest in avoiding situations where persons or companies who are, or have been, [Insert Company Name] Franchisees operate or otherwise become involved with, a Similar Business, anywhere, either during the term of, or after the termination or expiration of your rights under, this Agreement.*

*This mutual interest exists since, and you and we both agree that, (1) such activities would, as a practical and realistic business matter, mask use of techniques, methods, systems*

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<sup>22</sup> An excellent resource is Peter J. Klarfeld's (ed.) book *Covenants Against Competition in Franchise Agreements*, American Bar Association, Forum on Franchising (2d ed. 2003). Valuable information is provided on a state by state basis. Other state specific resources are also available, e.g., Michael L. Edwards & Michael D. Freeman, *Covenants Not to Compete in Ala. Revised*, 53 Ala. Lawyer 180, 180-88 (1992).

<sup>23</sup> Olson, K., et al., *The Annotated Franchise Agreement*, ABA Forum on Franchising (2010).

<sup>24</sup> *Id.* at 63.

<sup>25</sup> *Id.*

*and procedures learned by the operator while he/she/it was a [Insert Company Name] Franchisee, (2) the operation of a Similar Business, irrespective of location or vicinity to any existing or future [Insert Company Name] Franchise, including techniques not known to you or other operators prior to becoming a [Insert Company Name] Franchisee, (3) operation of such a business, and use of any such techniques, methods, systems and procedures, would damage both of and other [Insert Company Name] Franchisees and unfairly limit reasonable expansion alternatives open to us and our Franchisees, particularly in light of the limited number of goods and services provided by us and our Franchisees, particularly in light of the limited number of goods and services provided by us and our franchisees and the limited number of favorable locations or areas available, thereby placing us and other [Insert Company Name] operators at a competitive disadvantage, (4) there would be an extreme difficulty and expense involved in accurately determining actual financial impact from such activities by a current or former [Insert Company Name] Franchisee, (5) such activities would expose us and Franchisees to a strategy under which a person could acquire a [Insert Company Name] franchise, learn all of our methods of doing business including innovations by other [Insert Company Name] Franchisees, default under the franchise agreement or otherwise obtain termination or expiration and then open an unlimited number of locations drawing on their experience and training as a [Insert Company Name] Franchisee, including access to favorable locations, (6) the possibility of such occurrences would discourage the free flow of information and innovation within the [Insert Company Name] System, resulting in reduced growth and a decline in the values of the investments made by us and our Franchisees in [Insert Company Name] and the System, making subsequent sales or operation of [Insert Company Name] franchises in the area of Similar Business, and other areas, extremely difficult and placing us and our Franchisees at a disadvantage in the competitive marketplace, (7) such activities could reduce your level of time and attention given to your operation of [Insert Company Name] Program and thereby reduce its chances of success, (8) such activities would constitute an unfair and inequitable method of competition with us and other [Insert Company Name] Franchises and is the type of behavior to which you (as a [Insert Company Name] Franchisee) would strenuously object if engaged in by another [Insert Company Name] Franchisee, and (9) if we were unable to protect [Insert Company Name] Franchises from such (and other) adverse consequences due to violations of the provisions of this (or similar) agreements by current and/or former [Insert Company Name] Franchisees, it would be substantially more difficult to obtain, and retain, qualified [Insert Company Name] Franchisees for the general benefit of the [Insert Company Name] system, and would, therefore, injure the interests of [Insert Company Name] Franchisees not violating such provisions.*

*In addition, you acknowledge and agree that (1) you will receive valuable training and confidential information throughout the term of the Franchise, including, without limitation, information regarding our promotional, operational, sales, and marketing methods and techniques and the System which was not known to you before becoming a [Insert Company Name] Franchise, (2) we would be unable to protect such confidential information and other information and techniques against unauthorized use or disclosure, would be unable to encourage a free exchange of ideas and information among [Insert Company Name] franchisees and the goodwill and other assets of our business and those of other [Insert Company Name] Franchisees would be at risk if franchise owners and member of their immediate families were permitted to hold interests in or perform services for a Similar Business during or after the term of the Franchise Agreement, (3) your ownerships and/or operation of, or any other relationship with, Similar Business would necessarily benefit from, and e inconsistent with, your status and obligations as a [Insert Company Name] franchisee and (4) the requirements of this section have been expressly bargained for and are an express condition of our award of the Franchise to you.*

*You acknowledge that you've considered, as reasonable business alternatives, other franchise opportunities, as well as the possibility of your entering our industry as a non-franchised participant (in each instance not being subject to the restrictions of this Agreement), each of the restrictions on competition contained in this Agreement (including, but not limited to, those in this Section) are fair, reasonable and necessary for the protection of all member of the [Insert Company Name] family of companies, including you and your fellow [Insert Company Name] Franchisees and represent a reasonable balancing of the legitimate long-term interests of us, you and other [Insert Company Name] Franchisees, will not impose any undue hardship on you since you have other valuable opportunities, skills, experience, education and abilities unrelated to the ownership and/or operation of a [Insert Company Name] Program and which will provided you with the opportunity to derived significant income from other endeavors, that any burden on your resulting from the enforcement of such provisions will be entirely self-inflicted and that such enforcement will, in any event, be in the public interest by avoiding diversion of business, your self-enrichment and consequent impairment of the investment made in the [Insert Company Name] system by us and other Franchisees.*

*Therefore, to protect your and our investments and those all of [Insert Company Name] Franchisees, you and we agree as follows: during the term of this Agreement (and any other Franchise Agreement with us) and any extension thereof, and for two (2) years after any transfer, repurchase, the termination (whether for cause or otherwise) of your rights, the expiration of this (or any other) Agreement (without award of a successor franchise or renewal term), and/or the date on which you cease to operate your last [Insert Company Name] Program, whichever is later, neither you, any affiliate of yours, nor any shareholder, member or partner of yours (in the event you are or become a business entity) or any affiliates, shareholder or partner of yours will [except for [Insert Company Name] businesses operated in good standing under franchise agreements with us]: (a) have any direct or indirect interest as a disclosed or beneficial owner in any Similar Business located, or operating units located, anywhere; (b) have any direct or indirect interest (whether through a member of the immediate family of yours or any owner of you, or otherwise) as a disclosed or beneficial owner in any entity which is awarding franchises or licenses or establishing joint ventures or other business enterprises for the operation of Similar Businesses located, or operating units located, anywhere; (c) perform services as a director, officer manager, employee, consultant, representative, agent, or otherwise for any Similar Business or any entity which is awarding franchises or licenses or establishing joint ventures to operate Similar Businesses anywhere; or (d) directly or indirectly employ, or seek to employ, any person who is employed by us or any of the Franchise-Related Person/Entities or by any other [Insert Company Name] franchisee, nor induce nor attempt to induce any that person to leave said employment without the prior written consent of us and the at person's employer; provided that, in the event of a violation by you of the foregoing restriction, our remedies will include, at our election, (i) termination of your rights and our obligations under this and all other agreements, together with recovery of damages and all other remedies allowed at law and/or equity or (ii) payment to us by your of \$5,000 (subject to adjustment for inflation, as set forth in this Agreement), such amount having been mutually agreed on by your and us in view of the extreme difficulty in accurately determining the damages suffered by us as a result of your violation (including effects on relationships with other employees, customers, retraining costs, lost sales, etc.) and your and our mutual interest in avoiding a lengthy and costly dispute over damages, and in addition, you (and each affiliate of yours, together with each owner of you, if you are a business entity, and/or any affiliate of yours) will execute a General Release; provided further if the foregoing restriction regarding our and the employer's consent is unenforceable, you will first notify us and that employer before taking any action with respect to any such employment or offer of employment. You confirm that prior to entering into the franchised business you possessed (and still possess) valuable skills*

*unrelated to the franchised business, have the ability to be gainfully employed in other fields entirely acceptable to you and that the strict enforcement of the restrictions of this Agreement will not work any undue or significant hardship on your or your family.*

*If any of the restrictions of this Section are determined to be unenforceable due to excessive duration, geographic scope, business coverage or otherwise, you and we agree that they will be reduced to the level that provides the greatest restriction but which is still enforceable, notwithstanding any choice-of-law or other provisions in this Agreement to the contrary. The time period of the competitive restrictions described in this Agreement will be extended by the length of time during which you or any other person or entity are in breach of any provision of this Agreement (including the limitations of this Section.) The provisions of this Section will continue in full force and effect through the extended time period.*

*The restrictions of this Section don't apply to the ownership of shares, of a class of securities listed on a stock exchange or traded on the over-the-counter market, that represent less than three percent (3%) of the number of shares of that class issued and outstanding.*

*If you violate any obligations under this Agreement (or otherwise) with respect to a Similar Business, our remedies will include (but are not limited to) the right to obtain a temporary restraining order, preliminary and/or permanent injunction (or other equitable relief) notwithstanding any provisions of this Agreement to the contrary.*

*On our request, you will obtain written non-competition commitments from the persons subject to the non-competition provisions of this Agreement, in such form as we direct and naming you and us as beneficiaries of such agreements.*

*If the restrictions of this Section are unenforceable or are reduced to a level which we, in our sole and absolute discretion, find unacceptable, we may, in addition to any other remedies available to us, require you to pay a fee (either paid immediately on a present value basis or over time, as we select) of one-half (1/2) of the royalties and marketing contributions which would be payable if the business in question was a franchised [Insert Company Name] Program, for three (3) years, such amount having been jointly selected by you and us as fair and appropriate damages and in consideration of (1) the difficulty of accurately predicting actual damages, (2) the fact you will inevitably benefit in the operation of such business from your training and experience as a [Insert Company Name] Franchisee, (3) the possible impact on the expansion and operation of our system, including the expense and difficulty of a sale of a franchise in your area and (4) you not having any rights, nor we having any obligations, under this Agreement or otherwise during such period.*

**C. Does the Example of an Overly Complicated Provision Accomplish the Purpose for Which it was Intended?**

This provision is about as thorough as one can be. The question is whether it is necessary to accomplish its goal of discouraging and/or preventing franchisees and former franchisees from competing against the franchise system. While this provision certainly covers much of the ground that it should, it covers additional turf that, while interesting, educational for the franchisee, and not poorly drafted, is probably unnecessary. This provision spends the first two paragraphs—around 550 words or so—describing in great detail all of the reasons why a covenant not to compete is beneficial to both franchisor and franchisee alike. It is further cluttered with representations and acknowledgments of the franchisee regarding the value the franchisee is receiving in the bargain.

Eventually, we get to the actual restrictions. The difficulty with this drafting strategy is that it makes the specific restrictions exceedingly hard to find buried in a sea of explanations of why we are here in the first place. As noted above, enforceability is likely the first thought in the mind of one drafting a covenant not to compete. It is clear that the drafter of this provision had enforceability in mind as there is a distinct effort to elaborate on all of the legitimate business interests the franchisor claims in the franchise system. Such “legitimate business interests” are important for supporting enforcement of a non-compete provision. For example, confidentiality of franchise system information is often held to be a legitimate business interest.<sup>26</sup> In contrast, a prohibition against ordinary competition is not a legitimate business interest for the purpose of enforcing a covenant not to compete.<sup>27</sup> In this provision, the drafter has attempted to point out several legitimate business interests including “valuable training and confidential information” and “information regarding our promotional, operational, sales, and marketing methods and techniques and the System which was not known to you before”. It is conceivable this approach may help thwart arguments that a franchisee did not understand he/she was entering into a non-competition agreement. However, franchisees would likely counter that all of the clutter made the provision confusing or ambiguous; or perhaps even use it to argue that the lack of such language in other portions of the agreement makes those provisions not as important or enforceable.

It is relatively common to see a savings clause in a non-compete agreement, i.e. a provision that states that if any other provision is held to be unenforceable that the remaining provisions will remain in effect.<sup>28</sup> This non-compete goes a step further. Should the provisions be found unenforceable, the franchisee agrees to pay to franchisor a fee equal to half of what the franchisee would have to pay to the franchisor in royalties were the competing business a franchise. Consider California law where non-competition agreements are generally void. Could this clause be a creative solution or would a court in California see such a clause as just another restraint—albeit a purely economic one—on trade? This example illustrates a primary reason why drafting covenants not to compete is often so difficult. It is not enough to make sure the provision is clear and complete, the drafter must also pay close attention to the enforceability of the provision.<sup>29</sup>

#### **D. What is an Example of a Simpler Provision?**

##### **1. Covenant Not to Compete**

###### **a. In-Term**

*During the term of this Agreement, Franchisee and any guarantor(s) principals and controlling shareholders or interest holders (if Franchisee is a business entity), and the spouses of each such individual, covenant, individually not, directly or indirectly, to own an interest in,*

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<sup>26</sup> See *Diet Center, Inc. v. Day*, CCH Bus. Franchise Guide ¶ 9651 (D. Mass. March 19, 1990).

<sup>27</sup> See *Marcam Corp. v. Orchard*, 885 F. Supp. 294, 299 (D. Mass. 1995).

<sup>28</sup> The extent to which the covenant can be saved in the face of an offending provision is, once again, a function of state law. Some state courts will equitably reform the provision or “blue-pencil” the overbroad clauses. However, some state courts will void the entire covenant if there is an offending provision within the covenant. See, e.g., *Dent Wizard Int’l Corp. v. Brown*, 272 Ga. App. 553 (Ga. Ct. App. 2005).

<sup>29</sup> Carden et al., at 14 (providing a helpful resource for the “unusually long list of considerations in connection with the drafting of franchise covenants against competition”).

manage, operate, act as a consultant or employee in any Competitive Business. The purpose of this provision is to encourage Franchisee and any guarantor(s) to use their best efforts to promote the Franchised Business.

**b. Post Term**

Franchisee and any guarantor(s) principals and controlling shareholders or interest holders (if Franchisee is a business entity), and the spouses of each such individual (collectively referred to as the "Franchisee" for the remainder of this sub-section), covenant that, except as otherwise approved in writing by Franchisor, Franchisee will not, for a period of two years after the expiration or termination of this Agreement, regardless of the cause of termination, either directly or indirectly, for itself or through, on behalf of or in conjunction with any person, persons, partnership, corporation, limited liability company or other entity: (1) Own an interest in, manage, operate, act as a consultant with respect to the management or operation of any Competitive Business within a radius of 50 miles of the Authorized Location; (2) Have any direct or indirect ownership interest in any entity which has granted or grants franchises for the operation of a Competitive Business within 50 miles of the Franchisee's Authorized Location or within 10 miles of any other franchise, company or affiliate owned store; or (3) Initiate any action to hire, attempt to hire, or induce or seek to induce any person who is employed by Franchisor or employed by the franchisee of any other Franchised Business, or induce any such person to leave his or her employment or engagement, whether or not the person's employment is pursuant to a written agreement or is at will.

Each of the foregoing covenants will be construed as independent of any other covenant of this Agreement. If all or any portion of a covenant in this section is held unreasonable, then it will be amended to provide for limitations upon post-term competition to the maximum extent permitted by law. The running of any period of time specified in this section will be tolled and suspended for any period of time in which the Franchisee is found by a court of competent jurisdiction to have violated this restrictive covenant. Franchisor may at any time, in its sole discretion, revise any of the covenants in this section so as to reduce the obligations of Franchisee hereunder. Franchisee further expressly agrees that the existence of any claim it may have against Franchisor will not constitute a defense to the enforcement by Franchisor of the covenants in this section.

**E. Does the Example of a Simpler Provision Accomplish the Purpose for Which it was Intended?**

The above referenced provision accomplishes the purpose for which it is intended for several reasons. First, it broadly describes the forms of competition that are prohibited. It may not be enough for the franchisee to covenant not to compete only by owning another business. Consulting should be considered and probably addressed. Second, it narrows the prohibitions on the franchisee related to temporal length and geography. This provision is drafted as an example, but, as noted above, the applicable state law and policy, court precedent, and the circumstances of the franchised business will dictate just how narrowly or broadly such a provision may be drafted. Third, it bifurcates the prohibitions into in-term and post-term. As noted above, in-term prohibitions are not subject to the very close scrutiny that post-term prohibitions are. It would be a great mistake to draft a very narrow covenant not to compete in the franchise context without considering whether a broader and more restrictive covenant is appropriate while the franchisee agreement and the relationship is continuing.



The defined term “Competitive Business” is used in the example above, yet there is no definition. This was not unintentional. There are situations in which an overbroad scope can be problematic. When prohibitions are too broad, they begin to sound more like prohibitions on general economic competition and less like reasonable efforts to protect legitimate business interests. It is extremely important to appropriately tailor the competitive scope, geographical limit and time frame for these provisions to increase the odds that they will be enforced in the future. Otherwise, even a clear and concise non-competition provision runs the risk of being deemed, in whole or in part, unenforceable.<sup>30</sup>

Depending upon the type of franchise system you represent you may want to consider using some other types of post-termination restrictions that will provide effective tools to assist in deterring former franchisees from competing in the marketplace. Some common examples include the requirements that franchisees: provide the franchisor with lease rights; transfer ownership of their telephone numbers to the franchisor; physically transfer all electronic and paper copies of client lists and contact information and files; and to cooperate in the orderly transfer of their clients to the franchisor. Careful consideration should be given to what type of practical considerations will assist the franchisor in curtailing post-term unfair competitive behavior.

## **VI. WAIVERS**

### **A. What is the Purpose of the Provision?**

The waiver provision’s purpose is to preserve a party’s ability to enforce provisions of the agreement without dealing with equitable issues of waiver and delay, laches and similar defenses. It is especially important in long term agreements such as franchise agreements during the term of which the parties may not have enforced their rights in a strict and consistent manner.

Another issue a franchisor should consider addressing is the dichotomy between its obligations to single franchisees under its franchise agreements, and the responsibility it has to maintain a strong brand and franchise system. Enforcement of franchise agreement provisions is not necessarily uniform. For example, a franchisor may decide to support the efforts of franchisees in an area that has been subject to natural devastation by granting a temporary reduction in royalties. A franchisor may not terminate a franchisee that is chronically late in making payments or filing reports by a few days, but may want to terminate someone who is the subject of numerous customer complaints. Both could be subject to termination for repeated defaults, but the type of default and the effect on the system is crucial.

### **B. What is an Example of an Overly Complicated Provision?**

*Franchisor's waiver of any breach(es) under this or any other agreement (whether by failure to exercise a power or right available to Franchisor, failure to insist on strict compliance with the terms, obligations or conditions of any agreement, development of a custom or practice between Franchisee and Franchisor (or others) which is at variance with the terms of any agreement, acceptance of partial or other payments or otherwise), whether with respect to*

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<sup>30</sup> Guidance as to how to accomplish that goal can be found in numerous ABA Franchise Forum program materials and Franchise Law Journal articles on the drafting and enforcement of non-competition provisions. See *also Covenants Against Competition in Franchise Agreements*, American Bar Association, Forum on Franchising (2d ed. 2003).

*Franchisee or others, will not affect Franchisor's rights with regard to any breach by Franchisee or anyone else or constitute a waiver of Franchisor's right to demand exact compliance by Franchisee with the terms of this Agreement or otherwise. Subsequent or other acceptance by Franchisor of any payments or performance by Franchisee will not be deemed a waiver of any preceding or other breach by Franchisee of this Agreement or otherwise. The rights and remedies provided in this Agreement are cumulative and Franchisor will not be prohibited from exercising any rights or remedies provided under this Agreement or permitted under law or equity.*

*Franchisee and Franchisor, each believing that (1) having written documents as the only basis for Franchisor's legal relationship benefits each of Franchisor and Franchisee equally and reduces the risk of uncertainty in what should be a long-term business relationship and (2) this Agreement should be strictly interpreted according to its express terms, and each of Franchisor and Franchisee having a concern with (among other things) an approach whereby a court or arbitrator might impose (or limit or expand) rights and/or obligations with respect to either of Franchisor and Franchisee that were not expressly agreed to in writing by Franchisee and Franchisor, agree that Franchisee and Franchisor mutually and expressly waive and disavow any "implied covenant of good faith and fair dealing," similar doctrine, rule of interpretation or otherwise and that no such (or similar) doctrine, rule of interpretation or otherwise will have any application to Franchisee's and Franchisor's relationship, this Agreement or any other agreement between Franchisee and Franchisor (or any affiliate or the franchisor-related persons/entities) nor will affect Franchisor's ability to make binding changes to the System, the Manual(s) or otherwise. Neither Franchisee nor Franchisor have any expectation or agreement that Franchisee's or Franchisor's rights and obligations will be otherwise than as expressly set forth in this Agreement or that where any contractual provision allows Franchisee or us any discretion in action or otherwise, the exercise of that discretion will be limited in any way, whether by any "implied covenant of good faith and fair dealing," any similar doctrine or rule of interpretation or otherwise. No course of dealing between Franchisee and Franchisor, nor any course of dealing or agreement between Franchisor and anyone else, past, present or future, will affect Franchisee's or Franchisor's rights under this Agreement or otherwise. When Franchisor uses the phrase "business judgment" (or any similar phrase or concept), whether in this Agreement or otherwise, Franchisee agrees that there will be absolutely no limitation (including, but not limited to, any "implied covenant of good faith and fair dealing" or otherwise) on Franchisor's completely unrestrained ability and right to exercise that discretion in any way Franchisor choose. If, notwithstanding the provisions of this Section or otherwise, applicable law implies any covenant of good faith and fair dealing in this Agreement (which Franchisee and Franchisor agree it should not), Franchisee and Franchisor agree that such covenant shall not (i) imply any rights or obligations on Franchisee or Franchisor that are inconsistent with this Agreement, (ii) modify any provisions of this Agreement, (iii) create any cause of action in the absence of a violation of the express provisions of this Agreement and/or (iv) imply any rights or obligations that are inconsistent with a fair construction of the express provisions of this Agreement.*

*The parties acknowledge and agree that:*

*1. This Agreement (and the relationship between the parties) grants, in a number of instances, the Franchisor the sole and absolute discretion to make decisions, take actions and/or refrain from taking actions, and which may favorably or adversely affect the individual interests of any particular Franchisee. The Franchisor and the Franchisee agree that the Franchisor's ability to exercise its judgment and make decisions in its sole and absolute discretion in various areas, and without any limitation of any type, is necessary since a nation-*

*wide and international franchise system must (a) retain the flexibility to respond to opportunities, meet competitive challenges and operate in a dynamic (and to some degree unpredictable) business environment that will inevitably generate situations in which individual interests must be subordinated to the interests of the franchise system as a whole and (b) maintain flexibility to respond to evolving business conditions, in each case without limitation;*

*2. The Franchisor shall use its business judgment in exercising such discretion based on its assessment of its own interests and will not be required to consider the individual interests of the Franchisee or any other particular franchisee of the Franchisor, the Franchisee acknowledging that the Franchisor may make decisions based on considerations relating to the franchise system as a whole and which may favorably or adversely affect the individual interests of the Franchisee;*

*3. The Franchisor shall have no liability or other obligation to Franchisee for the exercise of its discretion in accordance with the provisions of this Agreement;*

*4. In no event shall any trier of fact, or judge or arbitrator, substitute its judgment for the business judgment so exercised by the Franchisor nor impose on the parties any duties or obligations not expressly undertaken by them; and*

*5. The provisions of this paragraph may be pleaded as a bar and as a complete defense to any action for an alleged breach of any duty.*

*If a duty of fair dealing in the performance and enforcement of this Agreement (or similar obligation) is imposed on the parties hereto by any applicable statute, court decision or otherwise (which Franchisee and Franchisor believe should not be so imposed, in consideration of Franchisee's and Franchisor's foregoing and other agreements), then the parties hereby acknowledge and agree that (a) any such duty will not (i) impose any rights or obligations on Franchisee or us that are inconsistent with this Agreement, (ii) modify any provisions of this Agreement, (iii) create any cause of action in the absence of a violation of the express provisions of this Agreement and/or (iv) imply any rights or obligations that are inconsistent with a fair construction of the express provisions of this Agreement, (b) performance and enforcement of this Agreement in accordance with its terms and in accordance with the exercise of the Franchisor's business judgment as described above will meet the requirements of such duty and (c) the Franchisor may terminate its obligations and Franchisee's rights hereunder, the Franchisor not having anticipated any imposition of obligations it had not expressly agreed to. You and Franchisor agree that, in any event and notwithstanding the imposition of any such duty or otherwise, this Agreement (and Franchisee's and Franchisor's relationship) gives us, and Franchisor retain, the entirely unrestricted right to make decisions and/or take (or refrain from taking) actions, even though such decisions may adversely affect Franchisee.*

**C. Does the Example of an Overly Complicated Provision Accomplish the Purpose for Which it was Intended?**

Attempting to draft away an implied covenant, such as the implied covenant of good faith and fair dealing, by express waiver is a questionable exercise. For example, the provision still refers to standards such as a "fair construction" of the terms. That will likely be a subjective analysis because what is fair to the franchisor may not be considered fair by the franchisee. Because a court will apply a standard of reasonableness, reserving the right to be unreasonable is likely to fail.

**D. What is an Example of a Simpler Provision?**

*No failure by either party to take action on account of any default of the other party, whether in a single instance or repeatedly, and no course of dealing of the parties in variance with the terms of this Agreement constitutes a waiver of any such default or of the performance required of either party by this Agreement. No express waiver by either party of any provision or performance hereunder or of any default by the other party constitutes a waiver of any other or future provision, performance or default. No waiver or extension of time shall be effective unless expressly contained in a writing signed by the waiving party. The parties may in their sole respective discretion elect from time to time to waive obligations of one another under this Agreement upon such terms and conditions as they may, in their sole respective discretion, set forth in such written waiver.*

*Franchisee acknowledges that in each case in which Franchisor may exercise any option or other right under this Agreement or under any agreement contemplated hereby, Franchisor may do so in its sole discretion, without liability or other obligation. So as to preserve the flexibility to deal with practical situations, Franchisor may, in its sole discretion, elect not to enforce (or to enforce selectively) any provision of this Agreement, or any other agreement, any policy or otherwise, whether with respect to Franchisee or any other franchisee and Franchisor may apply different policies to any franchisee, all without liability or other obligation, and any such acts or omissions will not limit or otherwise affect Franchisor's rights, whether to enforce this Agreement strictly or otherwise. Franchisee is aware of the fact that some present or future franchisees may operate under different forms of agreements, and consequently, that Franchisor's obligations and rights with respect to its various franchisees may differ materially.*

**E. Does the Example of a Simpler Provision Accomplish the Purpose for Which it was Intended?**

The waiver provision is mutual and allows both parties to condition waivers. This is important in a long-term agreement to provide flexibility to the parties. For the franchisor, it may also provide a mechanism to accommodate franchisees' needs without incurring the cost of regulatory compliance. For example, in California a material change to the franchise agreement may require the franchisor to provide disclosure and register the offer of a material change.<sup>31</sup> Structuring the change as a conditional waiver may avoid that consequence.

The second paragraph addresses the franchisor's unique position in being responsible for the welfare of the franchise system, and not merely its relationship with one particular franchisee. It does not attempt to deny the applicability of the implied covenant of good faith and fair dealing (which among other effects might offend a court or arbitrator), but rather explains the franchisor's position of having to make decisions necessary to preserve the system as a whole.

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<sup>31</sup> Cal. Corp. Code § 31125

## VII. INDEMNIFICATION OF THE FRANCHISOR

### A. What is the Purpose of the Provision?

The indemnity provision in the franchise agreement serves to protect the franchisor from liability associated with the franchisee's acts and omissions. This provision is required in order to protect the franchisor, its affiliates and their respective officers, directors, employees, agents, successors and assigns from third party claims. This clause may obligate the franchisee to defend such claims at the franchisee's cost and expense, but subject to the approval of the franchisor. It is preferable for the franchisor to retain the right to designate its own counsel and conduct its own defense but require that the costs will be borne by the franchisee. The franchisor's interest may extend beyond the specific claim being made as a result of the franchisee's actions because the franchisor must assess how the resolution of any specific claim will affect the franchise system. A settlement that makes economic sense under a particular set of facts may inadvertently encourage other plaintiffs to make similar claims against the franchisor and other franchisees.

The franchisor's goal is to avoid liability to third parties who have claims against the franchisee. Since those parties will often sue the franchisor as well as the franchisee if the claimant does not appreciate the franchise relationship, the franchisor must have a sufficiently broad indemnification provision. Indemnification provisions in general have been narrowly construed so the importance of drafting a clear and complete indemnity cannot be overstated.<sup>32</sup> In addition, the indemnification clause may serve the franchisor as a means of protection in vicarious liability claims.<sup>33</sup> The franchisor should resist any limitation based on negligence because this will result in allegations of negligence to avoid the obligation to indemnify the franchisor.

### B. What is an Example of an Overly Complicated Provision?

1. *Franchisee and each of the Controlling Principals shall, at all times, indemnify and hold harmless to the fullest extent permitted by law Franchisor, its affiliates, successors and assigns, their respective partners and affiliates and the officers, directors, shareholders, partners, agents, representatives, independent contractors, servants and employees of each of them (collectively, the "Indemnitees"), from all "Losses and Expenses" (as defined below) incurred in connection with any action, suit, proceeding, claim, demand, investigation or inquiry (formal or informal), or any settlement thereof (whether or not a formal proceeding or action has been instituted) which arises out of or is based upon any of the following:*

a. *The infringement, alleged infringement, or any other violation or alleged violation by Franchisee or any of the Controlling Principals of any patent, mark or copyright or other proprietary right owned or controlled by third parties (except as such may occur with respect to any right to use the Marks, any copyrights or other proprietary information granted hereunder pursuant to Section X.);*

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<sup>32</sup> *Commander Oil Corp. v. Advance Food Serv. Equip.*, 991 F.2d 49 (2d Cir. 1993).

<sup>33</sup> See Fiore, Rose Marie, *Vicarious Liability Cases: Duty to Defend and Conflicts of Interest*, Franchise Law Journal, (Spring 2006).

**b.** The violation, breach or asserted violation or breach by Franchisee or any of the Controlling Principals of any federal, state or local law, regulation, ruling, standard or directive or any industry standard;

**c.** Libel, slander or any other form of defamation of Franchisor, the system or any developer or franchisee operating under the System, by Franchisee or by any of the Controlling Principals;

**d.** The violation or breach by Franchisee or by any of the Controlling Principals of any warranty, representation, agreement or obligation in this Agreement or in any other agreement between Franchisee or any of its affiliates and Franchisor or any of its affiliates, or their respective partners, or the officers, directors, shareholders, partners, agents, representatives, independent contractors, servants and employees of any of them; and

**e.** Acts, errors, or omissions of Franchisee, any of Franchisee's affiliates and any of the Controlling Principals and the officers, directors, shareholders, partners, agents, representatives, independent contractors and employees of Franchisee and its affiliates in connection with the establishment and operation of the Restaurant, including, but not limited to, any acts, errors or omissions of any of the foregoing in the operation of any motor vehicle. The parties understand and agree that Franchisor cannot and does not exercise control over the manner of operation of any motor vehicles used by, or on behalf of, Franchisee or any employee, agent or independent contractor of Franchisee and that the safe operation of any motor vehicle is, therefore, Franchisee's responsibility.

**2.** Franchisee and each of the Controlling Principals agree to give Franchisor prompt notice of any such action, suit, proceeding, claim, demand, inquiry, or investigation. At the expense and risk of Franchisee and each of the Controlling Principals, Franchisor may elect to assume (but under no circumstance is obligated to undertake) or select counsel of its own choosing with respect to, the defense and/or settlement of any such action, suit, proceeding, claim, demand, inquiry or investigation. Such an undertaking by Franchisor shall, in no manner or form, diminish the obligation of Franchisee and each of the Controlling Principals to indemnify the Indemnitees and to hold them harmless.

**3.** In order to protect persons or property or its reputation or goodwill, or the reputation or goodwill of others, Franchisor may, upon written notice to and written consent from the Franchisee (which consent shall not be unreasonably withheld, delayed, or conditioned), consent or agree to settlements or take such other remedial or corrective action as it deems expedient with respect to the action, suit, proceeding, claim, demand, inquiry or investigation if, in Franchisor's reasonable judgment, there are reasonable grounds to believe that:

**a.** any of the acts or circumstance enumerated in Section X above have occurred; or

**b.** any act, error, or omission as described in Section X a result directly or indirectly in damage, injury, or harm to any person or any property.

**4.** All Losses and Expenses incurred under this Section shall be chargeable to and paid by Franchisee or any of the Controlling Principals pursuant to its obligations of indemnity under this Section, regardless of any actions, activity or defense undertaken by Franchisor or the subsequent success or failure of such actions, activity, or defense.

a. As used in this Section, the phrase “Losses and Expenses” shall include, without limitation, all losses, compensatory, exemplary or punitive damages, fines, charges, costs, expenses, reasonable attorneys’ fees, court costs, settlement amounts, judgments, compensation for damages to the Franchisor’s reputation and goodwill, costs of or resulting from delays, financing, costs of advertising material and media time/space, and costs of changing, substituting or replacing the same, and any and all expenses of recall, refunds, compensation, public notices and other such amounts incurred in connection with the matters described.

5. The Indemnitees do not assume any liability whatsoever for acts, errors, or omissions of any third party with whom Franchisee, any of the Controlling Principals, Franchisee’s affiliates or any of the offices, directors, shareholders, partners, agents, representatives, independent contractors and employees of franchisee or its affiliates may contract, regardless of the purpose. Franchisee and each of the Controlling Principals shall hold harmless and indemnify the Indemnitees for all Losses and Expenses which may arise out of any acts, errors or omissions of Franchisee, the Controlling Principals, Franchisee’s affiliates, the officers, directors, shareholders, partners, and employees of Franchisee and its affiliates, and any such other third parties unless (and then only to the extent that) the claims, obligations, or damages are determined to be caused by an Indemnitee’s negligence or willful misconduct in a ruling determined by a third party arbitrator pursuant to the procedures set forth in this Agreement. For purposes of clarification, any finding by a duly appointed third party arbitrator and/or a court with competent jurisdiction that the cause or causes of any such liability is jointly or partly due to the negligence of both an Indemnitee, on one hand, as well as the Franchisee (or any affiliate) or any Controlling Principal, on the other hand, shall not relieve the Franchisee and/or any Controlling Principal from the pro rata share of their indemnification obligations as contemplated herein.

6. Under no circumstances shall the Indemnitee be required or obligated to seek recovery from third parties or otherwise mitigate their losses in order to maintain a claim against Franchisee or any of the Controlling Principals. Franchisee and each of the Controlling Principals agree that the failure to pursue such recovery or mitigate loss will in no way reduce the amounts recoverable from Franchisee or any of the Controlling Principals by the Indemnitees.

7. Franchisee and the Controlling Principals expressly agree that the terms of this Section shall survive the termination, expiration or transfer of this Agreement or any interest herein.

**C. Does the Example of an Overly Complicated Provision Accomplish the Purpose for Which it was Intended?**

The provision above includes the controlling principals of the franchisee as persons primarily obligated to fulfill the indemnity obligation. However, is it not redundant to include them if those same persons will be required to sign an unlimited payment and performance guaranty? The franchise agreement in question requires that guaranty so if the franchisee does not honor its obligations under the indemnity to the franchisor, the principals will be responsible to the franchisor. Also, if the controlling principals are not signatories to the franchise agreement, how do they become primary obligors under the indemnity?

The provision lists all of the possible means by which the losses and expenses of the franchisor may be incurred: actions, suits, proceedings, claims, demands, investigations,

inquiries (formal or informal) and settlements. Is it necessary to include such a list in the indemnification provision? If the franchisee is taking on the responsibility for losses related to the ownership and operation of the restaurant and violations of law, does listing out the types of claims, with the risk of omitting a type that may arise, add anything of real value for the franchisor's protection?

In addition, the provision covers violations and breaches of the franchise agreement by the franchisee. The franchisor will have a direct right to enforce the franchise agreement against the franchisee irrespective of the addition of this coverage in the indemnity. This addition to the indemnification provision does not provide additional protection for the franchisor and does not need to be included. The provision also attempts to indemnify the franchisor for any acts of the franchisee that would be considered defamation. Again, the franchisor would have a direct claim against the franchisee for any such actions so including them in the indemnity provision does not provide any meaningful additional protection to the franchisor.

The provision does allow the franchisor to select its own counsel for its defense, at the expense of franchisee, but does so with an excessive amount of detail that may be omitted. It also describes in detail the types of settlements that the franchisor may agree to but since there is no obligation of the franchisor to settle, does this addition to the indemnity provide any real value to the agreement? Could a franchisee instead use it to claim that the franchisor had made certain promises regarding settlements that may not be warranted?

#### **D. What is an Example of a Simpler Provision?**

*Franchisee will, and hereby does, indemnify and defend Franchisor and its Affiliates and their respective officers, directors, owners, agents, representatives, employees, successors and assigns, from and against all losses, costs, liabilities, damages, claims, and expenses of every kind, including allegations of negligence by Franchisor and its Affiliates and their officers, employees, and agents, to the fullest extent permitted by Applicable Law, and including reasonable attorneys' fees, arising out of, resulting from or related to: (i) the unauthorized use of the Trademarks; (ii) the violation of Applicable Law; and (iii) the construction, renovation, upgrading, alteration, remodeling, repair, operation, ownership and use of the Restaurant. Franchisee must promptly give notice to Franchisor of any action, suit, proceeding, claim, demand, inquiry, or investigation related to the foregoing. Franchisor will have the right, through counsel of its choice, at Franchisee's expense, to control the defense and response to any such action, and such undertaking by Franchisor will not, in any manner, diminish Franchisee's obligations to Franchisor. Under no circumstances will Franchisor or a person indemnified be required to seek recovery from third parties or mitigate its losses in order to maintain a claim for indemnification against Franchisee under this Agreement, and the failure to pursue such recovery or mitigate a loss will in no way reduce the amounts recoverable from Franchisee by a person indemnified. Franchisee's obligations under this Section will survive the termination or expiration of this Agreement.*

#### **E. Does the Example of a Simpler Provision Accomplish the Purpose for Which it was Intended?**

The use of defined terms in the franchise agreement greatly reduces the need for repetition seen in the overly complicated provision. Here the use of the defined term 'Applicable Law' can shorten the provision as well as an all-inclusive definition for "Trademarks" which could include trademarks, service marks, copyrights, logos, slogans, patents, etc.



This provision does not repeat violations and breaches of the franchise agreement for which the franchisor has a direct contractual claim against the franchisee.

It also includes, to the extent permitted, all losses, which could include exemplary and punitive damages if permitted by the particular jurisdiction, but does not list as the overly complicated provision does many possible types of losses and damages. It is preferable to have a shorter, all-encompassing description instead of trying to list out all the possible types of losses and expenses that could be incurred with the risk of omitting some critical item. The provision also specifically provides that it covers claims of negligence against the franchisor and since many courts require that an indemnity covering a party's own negligence be "clear and unequivocal" for enforceability, this provision in the indemnity is critical.<sup>34</sup>

## VIII. TRANSFERS

### A. What is the Purpose of the Provision?

A very important provision in the franchise agreement for the franchisee is the one that addresses the franchisee's transfer rights and any restrictions imposed on those rights. Because the transfer section in most franchise agreements is quite long since it attempts to cover a number of transfer scenarios, we will discuss only three of the most commonly contemplated transfer provisions: transfer of the franchised business or a controlling ownership interest in the franchisee; transfer to a corporate entity; and transfer upon death or disability.

Nearly all franchise agreements do permit franchisees some right to transfer, even if it is subject to certain conditions. Franchisors generally want to foster transfers of the franchised business because it will create value in the brand. Transfers can also permit the franchisor to require updating or renovation of the unit and in many instances transfers will provide the franchisor with the opportunity to replace an older franchise agreement with the then-current form of agreement. Franchisors typically charge a fee for approval of any transfer to cover their expenses in processing a transfer, but in some instances may require payment of a percentage of the sales price and, most franchisors will require a release by the franchisee that is transferring the franchised business or the principal that is transferring its interest in the franchisee.

At least ten state franchise laws do address transfer rights of franchisees<sup>35</sup> and several prohibit franchisors from refusing to permit the transfer of a franchise without good cause.<sup>36</sup> Other laws require the franchisor to grant approval or disapproval in a certain time period once the request is received;<sup>37</sup> others state that the franchisor may not "unreasonably withhold

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<sup>34</sup> See *Mace v. Atl. Ref. & Mktg. Corp.*, 567 Pa. 71, 76 (Pa. 2001), which details the *Perri-Ruzzi* rule that states that if a party seeks to indemnify itself against its own negligence, the language seeking to do so must be clear and unequivocal. See *Ruzzi v. Butler Petroleum Co.*, 527 Pa. 1, 7 (Pa. 1991) (reaffirming *Perry v. Payne*, 217 Pa. 252 (Pa. 1907)).

<sup>35</sup> Ark. Code Ann. § 4-72-205 (1996); Cal. Bus. & Prof. Code § 25027 (1997); Haw. Rev. Stat. § 482E-6(2)(i) (1993); Ind. Code Ann. § 23-2-2.7-2(3) (1995); Iowa Code Ann. § 523H.5 (1997); Mich. Comp. Laws § 445.1527 (1989); Minn. Stat. Ann. § 80C.14(5) (1997); Neb. Rev. Stat. § 87-405 (1994); N.J. Stat. Ann. § 56:10-6 (1989); Wash. Rev. Code Ann. §19.100 (1989, 1997).

<sup>36</sup> Haw. Rev. Stat. § 482E-6(2)(i) (1993); Mich. Comp. Laws § 445.1527 (1989).

<sup>37</sup> Ark. Code Ann § 4-72-205 (1996); Neb. Rev. Stat. § 87-405 (1994); N.J. Stat. Ann. § 56:10-6 (1989)

consent.”<sup>38</sup> Notwithstanding what is provided in the franchise agreement, these state laws must be carefully reviewed if the franchise is subject to one (or more) of them.<sup>39</sup>

## **1. Transfer of the Franchised Business or a Controlling Ownership Interest in the Franchisee**

### **a. What is the Purpose of the Provision?**

Given that all franchise agreements are “personal” in nature and the franchise is granted based upon the attributes of the franchisee and its principals (business experience, financial qualifications and other considerations), the franchise agreement should address the process by which the franchisee may sell the franchised business, either through a sale of the real estate that comprises the franchised location, or a transfer of a lease to the franchised location or a transfer of the equity (shares of stock or membership interests) in the franchisee entity. Most franchise agreements provide that all transfers are subject to the franchisor’s consent and provide that the franchisor has considerable discretion to approve or refuse to approve the transfer. Other agreements provide that the franchisor may not unreasonably withhold its consent to a transfer and some agreements absolutely prohibit any transfer. All of these provisions may be subject to specific state laws that may curtail the rights of the franchisor in connection with a transfer.<sup>40</sup>

### **b. What is an Example of an Overly Complicated Provision?**

*If Franchisee shall desire to assign any of Franchisee’s rights hereunder, Franchisee shall serve upon Franchisor a written notice setting forth all of the terms and conditions of the proposed assignment, a suitable current financial statement regarding the proposed assignee and all other information reasonably requested by Franchisor concerning the proposed assignee. If Franchisor does not exercise its right of first refusal, Franchisor shall endeavor to communicate its consent or disapproval within 30 business days after the receipt of Franchisee’s notice (or if Franchisor requests additional information, within 30 business days after receipt of the additional information). If Franchisor does not notify Franchisee of its consent to the proposed assignment, then consent to the proposed assignment shall be deemed withheld. If the foregoing conflicts with any applicable law, the provision shall be modified, altered or amended so as to be in full compliance with such law. Consent to an assignment upon specified terms and conditions shall not be deemed to be a consent to an assignment upon any other terms or conditions, nor to any other person, nor to any subsequent assignment. Furthermore, such consent shall not be deemed or construed as a release of Franchisee (including Guarantors) from the obligations of this Agreement.*

*Any assignment, as defined above, sale or other transfer shall be subject to the following conditions, including the prior written consent of Franchisor, with respect to which Franchisor can consider whether the price and terms of payment will adversely affect the future operation of the Restaurant, it being understood by Franchisee that the following is not an exclusive list of*

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<sup>38</sup> Minn. Stat. Ann. § 80C.14(5) (1997); Wash. Rev. Code Ann. §19.100 (1989, 1997)

<sup>39</sup> See Levitas, C.L. & Hillman, A.P., *Hot Topics on Transfer and Assignment by Franchisees*, ABA Forum on Franchising (2005) for analysis of most transfer possibilities and relevant case law.

<sup>40</sup> For additional information on cases addressing transfer issues, see Dunn, T., *The Franchisor’s Control over the Transfer of a Franchise*, Franchise L.J. (Spring 2008).

*the conditions which Franchisor may impose upon an assignment, sale or other transfer prior to granting written consent:*

*i. Assignor (Franchisee) must satisfy fully all obligations to Franchisor or others arising out of the operation of the Restaurant;*

*ii. Assignee must satisfactorily demonstrate to Franchisor that it meets at least the same financial, managerial and character criteria required of franchisees acquiring a franchise from Franchisor;*

*iii. Franchisee and its shareholders if a corporation, or its partners if a partnership, must enter into an agreement with Franchisor providing that all obligations of the proposed assignee to make installment payments of the purchase price or interest thereon shall be subordinate to the proposed assignee's obligations to pay Royalties or Marketing Fund contributions, and to pay for purchases from Franchisor or Franchisor's affiliates. In addition to and without limitation of the foregoing, it shall be reasonable for Franchisor to disapprove any proposed transfer if, as a result thereof, the ownership interests in Franchisee will be, in Franchisor's reasonable business judgment, so widely held by different persons as to materially compromise the financial stake and dedication of those person(s) in whose individual or collective character, skill, attitude, and business ability Franchisor has placed reliance in entering into this Agreement or is willing to place reliance in approving such transfer;*

*iv. Assignee if an individual and, if assignee is a corporation or partnership, a shareholder or partner, together with assignee's General Manager, must agree to and actually attend Franchisor's training program, at a location designated by Franchisor, all at the assignee's sole cost and expense;*

*v. Franchisor must receive a general release of all claims by Franchisee;*

*vi. Assignee must execute the then current form of Franchise Agreement and all other documents customarily required by Franchisor;*

*vii. Payment to Franchisor of a transfer fee in the amount of Three Thousand Dollars (\$3,000); and*

*viii. Assignee has been furnished with any disclosure statements required by applicable law at least ten (ten) business days prior to the consummation of the proposed assignment or the payment of any consideration.*

**c. Does the Example of an Overly Complicated Provision Accomplish the Purpose for Which it was Intended?**

While the provision does set forth certain objective conditions for the franchisor's consent to the transfer, it also provides that the franchisor will have considerable discretion in approving any transfer. Instead of relying on the criteria that would be included in an application to be completed by the proposed transferee, the agreement requires that the franchisee provide the transferee's financial statement and any other information the franchisor may request. Instead of relying on the then-current form of franchise agreement's requirements as to the obligations of the transferee, the provision specifically sets out the obligation of the transferee to

attend a training program. Could not this requirement be eliminated from this provision since it will be included in the new franchise agreement? The provision requires that the franchisee provide a release of all claims, but is silent as to requiring a release from the guarantors as well. What the provision does not require is any upgrading or remodeling of the restaurant. This may be an important omission; since many franchisors rely on the transfer of the franchised business as a means to make certain that the units are updated to the then-current standards for the system. The notice requirements timing for a response and the result if there is not response are verbose.

**d. What is an Example of a Simpler Provision?**

*If Franchisee wishes to transfer the Restaurant, or if one or more Owners wish to Transfer a controlling Ownership Interest in Franchisee, or effect a transaction that otherwise results in a change of Control of Franchisee ("Transfer"), Franchisee will provide notice of the Transfer to Franchisor. The notice will state the full name of all the parties to the proposed Transfer, including the owners of such parties, together with all other related information that is requested by Franchisor. Within 30 days after Franchisor receives such notice and information, Franchisor will notify Franchisee of Franchisor's election of one of the following two alternatives:*

**i.** *Franchisor's consent to such Transfer, together with the conditions to such Transfer, including the following:*

**(a)** *Franchisee must be in full compliance under this Agreement, including without limitation, all of its accrued monetary obligations to Franchisor and its Affiliates, and will execute, in a form prescribed by Franchisor, a general release of all claims against Franchisor and its Affiliates, and their respective officers, directors, agents and employees;*

**(b)** *the transferee must enter into Franchisor's then-current form franchise agreement and relevant ancillary agreements, which will contain the standard terms (except for duration, as provided below) then being issued for new franchised Restaurants, including the then-current fees and charges. The new franchise agreement will be for a term that expires on or after the last day of the Term and provide for the upgrade of the Restaurant to address any needed renovations and to bring the Restaurant into compliance with Franchisor's then-current Standards;*

**(c)** *the transferee must certify in writing that: (i) Franchisor did not endorse, recommend, or otherwise concur with the terms of the Transfer, (ii) Franchisor did not comment upon any financial representations provided by Franchisee to transferee, and (iii) Franchisor did not participate in the determination of the consideration to be paid;*

**(d)** *the transferee must submit an application and pay the then-current application fee being charged franchisees;*

**ii.** *Franchisor's election not to consent to the transfer, and Franchisee will be in breach of this Agreement if Franchisee consummates the transfer.*

*Franchisor has the right, in its sole discretion, to elect not to consent to a Transfer under this Section if: (i) Franchisor determines that such transferee is not capable of successfully operating the Restaurant under the franchise agreement or the Standards; (ii) Franchisor*

*determines that the proposed transferee's overall financial status will not permit the Restaurant to be operated pursuant to the Standards; (iii) an uncured breach or default of a another agreement between Franchisee or its Affiliates and Franchisor exists; (iv) upon execution by transferee of a new franchise agreement, the transferee would be in breach of such agreement; or (v) the Transfer is to a Competitor of Franchisor or to a Specially Designated National or Blocked Person with whom Franchisor is prohibited to do business.*

**e. Does the Example of a Simpler Provision Accomplish the Purpose for Which it was Intended?**

This provision covers not just a sale of the franchised unit but changes of control of the franchisee (for example, transfer of shares of a corporate entity franchisee) such that the entity to whom the franchisor had agreed to grant the franchise has substantially changed and given the personal nature of the franchise agreement, such change would have to be subject to franchisor's consent. The provision details the primary conditions for approval of a new franchisee: complete application and payment of the application fee, all required information and documentation relating to the transferee, upgrading of the franchised business unit, a release of the franchisor, execution of a new franchise agreement on the franchisor's then-current form, payment by the franchisee of all fees and charges owed to the franchisor. The provision also details the legitimate business and legal issues that would prevent the franchisor's consent to such transfer. Of course, state franchise laws that contain provisions regarding transfers would also control if applicable to the franchise.<sup>41</sup> While this provision is not that much shorter than the overly complicated sample provision, it makes use of certain previously defined terms such as "Control" and "Competitor" and it states the standard of review by the franchisor ("sole discretion") and details the reasons for which the franchisor may not consent to the proposed transfer. Setting forth the standard of review is important to avoid the imposition of a "reasonableness" limitation under an implied covenant of good faith and fair dealing.<sup>42</sup>

**2. Transfer to an Entity by the Franchisee**

**a. What Is the Purpose of the Provision?**

An individual may enter into a franchise agreement prior to consideration of the value of creation of a corporation, limited liability company, or other entity as a means to limit the individual's liability to third parties in connection with the ownership and operation of the franchised business or for tax planning advantages. Franchisors are generally willing to accept the transfer of the franchise agreement to an entity owned by the individual the franchisor had approved as a franchisee as long as the individual franchisee guarantees the performance of the transferee entity to the franchisor. Increasingly, franchisors are requiring that individuals create an entity in order to avoid the characterization of the franchisee as an employee instead of an independent contractor.<sup>43</sup> It is also possible that an existing entity may execute the franchise agreement as franchisee, but the owners may later decide that for tax, accounting, or other structuring reasons to create a new entity to serve as franchisee. Most franchise agreements provide transfer rights for these possibilities in order to provide the franchisee a certain amount of flexibility in its organization.

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<sup>41</sup> *Id.*

<sup>42</sup> *Prestin v. Mobil Oil Corp.*, 741 F.2d 268 (9th Cir. 1984).

<sup>43</sup> *Awuah v. Coverall N. Am., Inc.*, 707 F. Supp. 2d 80 (D. Mass. 2010) (citing Mass. Gen. Laws ch. 149, § 148B).

**b. What Is an Example of an Overly Complicated Provision?**

i. *Franchisee shall not incorporate without the prior written approval of Franchisor, which approval shall not be unreasonably withheld. However, in such event, Franchisee and all shareholders and their spouses, shall jointly and severally, execute either the Assignment of Franchise Agreement and Guaranty (Exhibit "G" hereto) or Personal Guaranty (Exhibit "H" hereto).*

ii. *In the event that Franchisee or any successor of Franchisee becomes a corporation, Franchisee will furnish Franchisor with:*

(a) *a shareholder's agreement, executed by all of the shareholders of Franchisee, stating that no such shareholder will sell, assign, or transfer any of his stock to any person or company without the written consent of Franchisor;*

(b) *a resolution of the board of directors, which has been ratified by the shareholders of Franchisee, stating that no unissued stock in Franchisee will be issued to any person or company other than the then shareholders of Franchisee, without the written consent of Franchisor;*

*In the event of a violation of the provisions of Sub-subparagraphs (a) or (b) above, or in the event stock is sold, assigned, transferred, or issued in violation of such shareholder's agreement or resolution, Franchisor shall have the option and right, after giving Franchisee thirty (30) days' written notice in which to cure such violation, to forthwith cancel and terminate this Agreement, and thereupon the rights of Franchisee hereunder shall cease, but such termination shall not affect the rights hereunder of Franchisor to take action or abstain from taking action after the termination, as provided elsewhere in this Agreement.*

**c. Does the Example of an Overly Complicated Provision Accomplish the Purpose for Which it was Intended?**

The provision set forth above does not permit the franchisee to create a new entity without the franchisor's approval and while it does require certain persons to provide guaranties of the new entity's obligations to the franchisor, it does not detail the new documentation that will be required by the franchisor to evidence the transfer of the franchise agreement or the information about the new entity the franchisor will require, but instead focuses on the restrictions to be imposed in the new entity's corporate documents that require certain consents of the franchisor for issuance or transfer of shares. The provision only envisions the creation of a corporation with stock (not other types of limited liability entities) and may, therefore, prove difficult for enforcement by the franchisor if a different type of entity is to be created. If there is an unapproved transfer of the shares of the new entity, the provision is cumbersome in its description of the franchisor's rights.

**d. What is an Example of a Simpler Provision?**

*During the first six months of the initial term of this Franchise Agreement, Franchisee or all the Owners of Franchisee will be permitted to make one Transfer to a transferee entity owned by the Franchisee, if the Franchisee is an individual, or owned by the Owners in the same proportions as set forth in this Franchise Agreement, without payment of a transfer fee, by assigning this Franchise Agreement to the transferee in a form of assignment and assumption agreement acceptable to Franchisor, the execution of such Guarantees by Owners as may be*

required by Franchisor, and such transferee providing Franchisor any corporate or other organizational documents Franchisor may require.

**e. Does the Example of a Simpler Provision Accomplish the Purpose for Which it was Intended?**

This provision provides flexibility to the franchisee and its owners, but limits the time period for which a transfer may be made to a newly created entity without the payment of a transfer fee to the franchisor. It requires that the ownership of the new entity be the same as that reflected in the original franchise agreement; it clearly states the documentation that the franchisor will require; it clearly requires that owners will execute new guaranties and provide all the organizational documentation the franchisor requires.

**3. Transfer Upon Death or Disability**

**a. What is the Purpose of the Provision?**

Most franchise agreements foresee the possibility of the death or disability of the franchisee, if an individual, or the principal owner of the franchisee, if an entity, and provide that the executor, administrator or other representative may transfer the agreement to a franchisee approved by the franchisor as long as such transfer occurs in a reasonable period of time after the death or disability and the transferee is qualified to operate the franchise and completes required training or hires an operator approved by the franchisor. Particularly for franchise systems that generally depend on the operation of the franchise by the individual owners of the franchisee, the franchise agreement should include a definition of incapacitation or disability in order to avoid disputes regarding such condition. Franchisors must recognize, however, that certain state statutes may provide rights to heirs of a franchisee that will trump the provisions of the franchise agreement.<sup>44</sup> The business purpose of the provision is to assure the appropriate continuation of the franchised business in the event of death or disability of a key individual and to provide protections to the franchisor that the franchise will continue to be operated by a qualified person.

**b. What is an Example of an Overly Complicated Provision?**

*i. Upon the death of Franchisee (if Franchisee is a natural person) or any Controlling Principal who is a natural person and who has interest in this Agreement, the Restaurant or Franchisee (in each instance, the "Deceased"), the executor, administrator or other personal representative of the Deceased shall transfer such interest to a third party approved by Franchisor within twelve (12) months after the death, subject to the restrictions referenced in Section X below. If no personal representative is designated or appointed or no probate proceedings are instituted with respect to the estate of the Deceased, then the distributee of such interest must be approved by Franchisor. If the distributee is not approved by Franchisor, then the distributee shall transfer such interest to a third party approved by Franchisor within twelve (12) months after the death of the Deceased, subject to the restrictions referenced in Section X below:*

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<sup>44</sup> Cal. Bus. & Prof. Code § 25027 (1997); Haw. Rev. Stat. § 482E-6(2)(i) (1993); Ind. Code Ann. § 23-2-2.7-2(3) (1995); Iowa Code Ann. § 523H.5 (1997)

ii. Upon the permanent disability of Franchisee (if Franchisee is a natural person) or any Controlling Principal who is a natural person and who has an interest in this Agreement, the Restaurant or Franchisee (in each case, the "Injured Person"), Franchisor may, in its reasonable discretion, require such interest to be transferred to a third party in accordance with the conditions described in this Section X within six (6) months after notice to Franchisee. "Permanent Disability" shall mean any physical, emotional or mental injury, illness or incapacity which would reasonably prevent a person from performing the obligations set forth in this Agreement or in the guaranty made part of this Agreement for at least ninety (90) consecutive days and from which condition recovery within ninety (90) days from the date of determination of disability is unlikely. Permanent Disability shall be determined by a licensed practicing physician approved by both Franchisor and the Injured Person or the Injured Person's surrogate in the event Franchisee is unable to make such a selection); provided, however, that if the Injured Person refuses to submit to an examination, then such person shall automatically be deemed permanently disabled as of the date of such refusal for the purpose of this Section X. The costs of any examination required by this Section shall be paid by Franchisor. Approval of a physician selected by Franchisor or the Injured Person shall not be unreasonably withheld, delayed, or conditioned by the other party. In addition, the review and approval process of the physician selected will primarily include (i) whether the physician is in fact licensed to practice and is in good standing, and (ii) whether the costs charged by the physician are commensurate with the costs typically charged by other physicians in his/her field.

iii. Upon the death or claim of Permanent Disability of Franchisee or any Controlling Principal, Franchisee or a representative of Franchisee must notify Franchisor of such death or claim of Permanent Disability within ten (10) days of its occurrence. Any transfer upon death or Permanent Disability shall be subject to the same terms and conditions as described in this Section for any inter vivos transfer; provided, however, such transfers shall not be subject to the five thousand dollar (\$5,000) transfer fee described in Section X. If an interest is not transferred upon death or Permanent Disability as required in this Section, then such failure shall constitute a material event of default under this Agreement.

**c. Does the Example of an Overly Complicated Provision Accomplish the Purpose for Which it was Intended?**

While this provision does address the death of the franchisee or its controlling person, it only provides that a transfer must occur within 12 months of such death. It does not address the continued operation of the franchised business during such extended period of time. The use of the defined terms "Deceased" and "Injured Person" could have possibly been avoided as well as the somewhat confusing undefined term "distributee." As to disablement of the franchisee, the provision does include a definition but also provides a detailed procedure for such making such determination and requires the franchisor to pay the expenses of any physician's decision required. The provision's detail as to the physician and selection of the physician does not seem warranted in most cases, but could provide a franchisee with many opportunities for dispute with the additional burdens placed on the franchisor if the franchised business is not being properly operated. The provision does provide a cross-reference to the other requirements in the franchise agreement for the transfer to become effective instead of listing those requirements again.

**d. What is an Example of a Simpler Provision?**

*In the event of the death of Franchisee (if a corporate Franchisee, the shareholder in control, and if a partnership, the managing partner and if a limited liability company, the*



*managing member), the franchise granted by this Agreement may pass by will or intestate succession, provided the Restaurant is operated in accordance with this Agreement during any period of probate or administration. Any transfer by will or intestate succession, or the transfer of this franchise by the executor or administrator of Franchisee's estate will be considered to be a transfer requiring compliance with the provisions of this Article, including the requirements of Franchisor's written approval of the assignee, qualifications and training, execution of agreements, and the payment of the transfer fee.*

*In the event of Incapacity of Franchisee (if a corporate Franchisee, the shareholder in control, if a partnership, the managing partner and if a limited liability company, the managing member), the franchise granted by this Agreement may be transferred or sold to a transferee acceptable to Franchisor within six months after the Incapacity of Franchisee, provided the Restaurant is operated in accordance with this Agreement during such period. Any such transfer will be considered to be a transfer requiring compliance with the provisions of this Article, including the requirements of Franchisor's written approval of the assignee, qualifications and training, execution of agreements, and the payment of the transfer fee. "Incapacity" means the usual participation of the Franchisee (if a corporate Franchisee, the shareholder in control, if a partnership, the managing partner and if a limited liability company, the managing member) in the Restaurant is curtailed for any reason for a period of 90 consecutive days during the term of this Agreement.*

**e. Does the Example of a Simpler Provision Accomplish the Purpose for Which it was Intended?**

This provision includes the right of transfer upon death or disability of the franchisee but requires the continued satisfactory operation of the franchised business until such transfer may occur. In such event, any transferee must meet franchisor's qualifications, complete training and provide all information requested by franchisor (including background information, corporate information) and must sign all documentation (such as assignment and assumption agreements) and pay a transfer fee. By including a definition of incapacity and certain timing requirements, it should reduce the possibility of a dispute between the franchisee and the franchisor regarding such determinations.

**IX. RENEWALS**

**A. What is the Purpose of the Provision?**

An important determination in any franchise relationship is whether or not the franchisee is going to have any contractual renewal rights upon the expiration of the initial term of the franchise agreement. Some franchisors with substantial bargaining power offer no renewal rights in order to have maximum flexibility at the expiration of the term in the determination of whether or not to renew the franchise. At such time, the franchisor will be able to establish the conditions that must be met in order for the franchisee to continue as part of the franchised system, which generally include a substantial upgrade of the premises, the payment of a renewal fee and the execution of the then-current form of franchise agreement which may require the payment of a different royalty fee and advertising fee. In other franchise systems, the franchisor may offer renewal rights to encourage a long term interest by franchisees in the franchised business. Conditions might be such that the franchisor will not be able to sell franchises without such a right. Franchisees will not commit without assurance that they will be able to own the franchise a sufficiently long period of time to reap the financial rewards based upon the amount of initial and on-going investments anticipated to maintain the franchise.

If a renewal right is granted, the conditions required should be clearly stated in the franchise agreement in order to set the expectation of the franchisee and avoid any confusion or disputes at the expiration of the franchise agreement about the requirements for the franchisee to remain in the system. Of course, franchisors must consider applicable state laws at the time of any expiring franchise agreement, whether or not the franchise agreement grants any renewal rights to the franchisee. These laws have been enacted to protect franchisees and may place certain restrictions on nonrenewal of a franchise agreement. For example, some statutes require franchisors to provide notice of non-renewal or have “good cause” for nonrenewal notwithstanding what the franchise agreement may provide.<sup>45</sup> Good cause may include the franchisee’s failure to comply with the “material and reasonable obligations” of the franchise agreement<sup>46</sup> or even that the franchisee was also given a notice and opportunity to cure.<sup>47</sup> Currently, the statutory notice period for non-renewal runs as long as one hundred eighty days in certain jurisdictions,<sup>48</sup> and even up to a year for franchises subject to the laws of Washington.<sup>49</sup> In some states, non-renewal is permitted if certain conditions are met; in others, non-renewal is permitted as long as it is consistent with the franchisor’s current practices and is non-discriminatory.<sup>50</sup> In one state, non-renewal is not permitted unless the franchisor compensates the franchisee for the fair market value of the inventory, equipment and supplies it was required to purchase if the agreement’s term is less than 5 years and the notice of non-renewal was less than 6 months.<sup>51</sup> In Illinois, upon non-renewal, the franchisor must compensate the franchisee for the decrease in the value of the franchised business unless any non-competition requirement is waived and the franchisee received the 180 days’ notice of non-renewal.<sup>52</sup>

## **B. What is an Example of an Overly Complicated Provision?**

1. *Franchisee may, at its option, renew the rights under this Agreement for additional consecutive terms of five (5) years each (provided that such renewal term shall automatically terminate upon the expiration or termination of Franchisee’s right to possess the Restaurant premises), subject to the any or all of the following conditions which must, in Franchisor’s sole discretion, be met prior to and at the time of renewal:*

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<sup>45</sup> N.J. Rev. Stat. §§ 56: 10-1 to 56:10-12 (1993), Wis. Stat. §§ 135.01 to 135.07 (1993-94), Iowa Code §§ 523H.1 to 523H.171, 537A.10 (1995).

<sup>46</sup> Conn. Gen. Stat. Ann. §§ 42-133e to 42-133h (1995).

<sup>47</sup> Haw. Rev. Stat. §§ 482E-1 to 482E-12 (1988).

<sup>48</sup> Cal. Bus. & Prof. Code §§ 20000 to 20043 (1993); 815 Ill. Rev. Comp. Stat. §§ 705/18 to 705/26 (1992); Iowa Code § 523H.1 to 523H.17, 537A.10 (1995); Minn. Stat. § 80C.14 (1993); and Minn. R. § 2860.4400 (1989).

<sup>49</sup> Wash. Rev. Code §§ 19.100.180 to 19.100.190 (1991).

<sup>50</sup> Ark. Code Ann. §§ 4-72-201 to 4-72-210 (1987); Haw. Rev. Stat. §§ 482E to 482E-12 (1988).

<sup>51</sup> Mich. Comp. Laws §§ 4451.1527, 445.1535 (1989).

<sup>52</sup> 815 Ill. Rev. Comp. Stat. §§ 705/18 to 705/26 (1992). For detailed discussion of cases interpreting certain state renewal statutes, see Modell, C.S. & Beck, G.A., *Franchise Renewals—“You Want Me to Do What?”*, Franchise L.J. (Summer 2002) and Tractenberg, C.R. et al., *Legal Considerations in Franchise Renewals*, Franchise L.J. (Spring 2004).

**a.** Franchisee shall give Franchisor written notice of its election to renew not less than seven (7) months nor more than twelve (12) months prior to the end of the initial term or newel term, as applicable;

**b.** Franchisee shall repair or replace, at Franchisee's cost and expense, equipment (including electronic cash register or computer hardware or software systems inclusive of any software upgrades required of Franchisee), signs, interior and exterior décor items, fixtures, furnishings, catering or delivery vehicles, if applicable, supplies and other products and materials required for the operation of the Restaurant as Franchisor may reasonably require and shall obtain, at Franchisee's cost and expense, any new or additional equipment, fixtures, supplies and other products and materials which may be reasonably required by Franchisor for Franchisee to offer and sell new menu items from the Restaurant or to provide the Restaurant's services by alternative means such as through carry-out, catering or delivery arrangements and shall otherwise modernize the Restaurant premises, equipment (including electronic cash register or computer hardware or software systems), signs, interior and exterior décor items, fixtures, furnishings, catering or delivery vehicles, if applicable, supplies and other products and materials required for the operation of the Restaurant, as reasonably required by Franchisor to reflect the then-current standards and image of the System and as contained in the Manuals (as defined in Section X or otherwise provided in writing by Franchisor);

**c.** Franchisee shall not be in material default of any provision of this Agreement, any amendment hereof or successor hereto, or any other written agreement between Franchisee or any of its affiliates and Franchisor or any of its affiliates; and Franchisee shall have substantially and timely complied with all the terms and conditions of such agreements during the terms thereof;

**d.** Franchisee shall have satisfied all monetary obligations owed by Franchisee to Franchisor and its affiliates under this Agreement and any other agreement between Franchisee or any of its affiliates and Franchisor or any of its affiliates at the time of any renewal and shall have timely met those obligations throughout the terms thereof;

**e.** Franchisee shall present satisfactory evidence that Franchisee has the right to remain in possession of the Restaurant premises or obtain Franchisor's approval of a new site for the operation of the Restaurant for the duration of the renewal term of this Agreement;

**f.** Franchisor, Franchisee and the Controlling Principals (as defined in Section X shall execute a general release, in a form reasonably satisfactory to each of any and all claims against each other, their affiliates, and their respective partners, officers, directors, shareholders, agents, representatives, independent contractors, servants and employees of each of them, in their corporate and individual capacities including, without limitation, claims arising under this Agreement or under federal, state or local laws, rules and regulations or orders; and

**g.** Franchisee shall comply with Franchisor's then-current financial qualifications and training requirements.

**C. Does the Example of an Overly Complicated Provision Accomplish the Purpose for Which it was Intended?**

This renewal provision provides that the franchise agreement may become “evergreen” at the election of the franchisee as long as it meets the conditions stated in Sections (1) through (7). For this potentially extensive period of time, the franchisor will not be able to increase the royalty fee or the advertising fund fees required by the agreement (even if newer franchisees are paying different fees), will not be able to require the renewing franchisee to execute the then-current form of franchise agreement (with additional or different requirements based on the evolution of the system, differing product and market demands, or legally beneficial provisions based on the development of franchise law during such period), will not be able to require the payment of any renewal fee (many franchisors charge a percentage of the then current initial fee or some other reduced amount), will not be able to revise the insurance requirements or change other specifically-negotiated provisions of the franchise agreement (such as any territorial protection provisions that continued for the full term of the agreement). Unless the franchisor actually intended to forgo all of these possibilities as the franchise system developed, the provision may not have been drafted to provide the flexibility that the franchisor will reasonably need to develop its system for the benefit of the entire system.

The provision does state in detail the items in the restaurant that the franchisee must repair and replace. The risk of such an extensive list is that something may be omitted. It may be preferable to state that the restaurant must comply with the then-current standards or provide that the franchisor will inspect the premises and provide to the franchisee a list of items (property improvement requirements) that must be in place by a certain date in order for the franchise agreement to continue.

Given that the franchisee has been operating the franchised business and is required to have been in compliance with the terms of the franchise agreement, it does not seem appropriate to require that the franchisee comply with the then-current training requirements in order to obtain the renewal of the agreement. Most systems include the training requirements in the standards or manual and the agreement should provide that the franchisee must be in compliance with such standards or manual requirements as they are amended and revised throughout the term of the agreement. As to compliance with the franchisor’s financial qualifications, this requirement does not seem particularly meaningful if the franchisee is in compliance with the other payment and performance obligations set forth in the renewal provision, particularly if a guaranty of the franchisee’s obligations is required by the principals of the franchisee.

**D. What is an Example of a Simpler Provision?**

*Franchisee may, at its option, renew this franchise for one additional period of ten (10) years, provided that at the time of renewal:*

*1. Franchisee gives Franchisor written notice of such election to renew not less than six months nor more than 12 months prior to the end of the Term; requests that Franchisor inspect the Restaurant to determine renovation and upgrade requirements; and pays Franchisor a renewal fee of one-half of Franchisor’s then current initial franchise fee;*

*2. Franchisee executes Franchisor’s then-current form of franchise agreement, which may include a higher royalty fee and a higher advertising contribution than that contained in this Agreement as well as other requirements, including an obligation to*

*upgrade the Restaurant to address any needed renovations to bring the Restaurant into compliance with Franchisor's then current Standards pursuant to a property improvement plan made a part of the new franchise agreement;*

*3. Franchisee executes a general release in a form satisfactory to Franchisor of all claims against Franchisor and its Affiliates and their respective officers, directors, agents and employees; and*

*4. Franchisee is not in breach of any provisions of this Agreement, and no other agreements between Franchisee and its Affiliates and Franchisor and its Affiliates are in default.*

**E. Does the Example of a Simpler Provision Accomplish the Purpose for Which it was Intended?**

If the intent of the franchisor is to grant a renewal right to the franchisee, this provision provides that right but sets forth a specific term for such renewal period instead of providing the franchisee a continuing right to renew the franchise. It provides the requirements for such renewal, but the list is shorter and should eliminate issues regarding renovation requirements by allowing those to be determined at the time of the renewal request. It also eliminates "materiality" and "reasonable" qualifiers that could be subjective and, therefore, the subject of a dispute regarding the opinion or discretion of the franchisor.

The revised provision also sets forth a fee for the renewal. Some franchisors may charge a full application fee while others may charge a percentage fee based upon the gross revenues of the franchised business over some set period of time. It is not uncommon to have the fee tied to the then-current initial franchise fee, but of course, that fee may be greater than the amount the franchisee paid for its initial franchise.

Given that the revised provision provides that the franchisee must execute the franchisor's then-current form of franchise agreement, it will be important for the franchisor to comply with its disclosure obligations since the new agreement would likely be considered the grant of a new franchise to the existing franchisee. The franchisor must take these obligations into account and permit the appropriate holding period to expire prior to the execution of the renewal franchise agreement or the receipt of the required fees. Including an obligation to execute a new franchise agreement in a renewal provision was held not to violate a state law that protects franchisees' renewal rights by prohibiting a failure to renew except for "good cause."<sup>53</sup> Including an obligation to execute a new franchise agreement that required remodeling and changes to advertising and the franchise fee was also held not to violate a state law that prohibits changes in the franchisee's "competitive circumstances" upon renewal.<sup>54</sup>

**X. CHOICE OF LAW, FORUM SELECTION AND VENUE**

**A. What is the Purpose of the Provision?**

Choice of law, forum selection and venue provisions are often discussed collectively when such provisions are the subject of articles and presentations. Yet, it is not uncommon to

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<sup>53</sup> *Ziegler Co., v. Rexnord, Inc.*, 147 Wis. 2d 308 (Wis. 1988).

<sup>54</sup> *Bresler's 33 Flavors Franchising Corp. v. Wokosin*, 591 F. Supp. 1533 (E.D. Wis. 1984).

find choice of law and forum/venue provisions presented separately in franchise agreements, and therefore, each topic will be addressed independently.

## 1. **Choice of Law**

### a. **What is the Purpose of the Provision?**

The purpose of a choice of law provision is to memorialize the intention of the franchisee and franchisor to select the applicable law that will govern any disputes that may arise out of a franchise agreement. Generally, great deference is paid to the parties' choice of law.<sup>55</sup> From a franchisor perspective, appropriate selection of the applicable law can have a significant impact on the results of disputes with franchisees. A well-known example is the selection of California law and the significant negative impact such a selection may have on the enforceability of a non-competition provision in the franchise agreement. A major goal in having a choice of law provision is to create some certainty and predictability to the relationships between a franchisor and several franchisees located in different jurisdictions.<sup>56</sup>

In less complex agreements, it is common to find extremely simple choice of law provisions. An example of these often "one-liners" is: "This Agreement shall be construed and interpreted in accordance with the substantive laws of the State of \_\_\_\_\_." This provision is certainly concisely written. And in a general sense it accomplishes the purpose for which it was intended very clearly: the state law that will apply to the agreement will be local law. In the context of many contractual agreements, this may well be all that is needed. However, in the franchise agreement context, this provision is not enough. The provision's failure to address the impact of state franchise laws is a substantive shortfall. Moreover, in the presence of an arbitration provision, such a short choice of law provision would also fail to appropriately address the Federal Arbitration Act or other federal law that may well be controlling. Technically, the short provision may be sufficient in this regard considering no choice of state law provision will prevent pre-emption by a controlling federal statute. However, mention of federal law lends clarity to the provision and can be done without much extra drafting.

### b. **What is an Example of an Overly Complicated Provision?**

*You and we, both agreeing on the practical business importance of certainty as to the law applicable to your and our relationship and its possible effect on the development and competitive position of the Franchise System, jointly agree that, except with respect to the applicability of the Federal Arbitration Act, 9 U.S.C. § 1 et seq. and the effect of federal pre-emption of state law by such Act and except to the extent governed by the United States Trademark Act and other federal laws, or as provided elsewhere in this Agreement, this Agreement (including any claims, counter-claims or otherwise by you and/or any affiliate of yours) and all other matters concerning you (and/or any affiliate of yours) and us (and/or any affiliate of ours), and/or you (and/or any affiliate of yours) and any of the Franchisor-Related Persons/Entities, including your/our/their respective rights and obligations, will be governed by, and construed and enforced in accordance with, the laws of the state where your Franchised*

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<sup>55</sup> See Restatement (Second) of Conflict of Laws § 187 (2003); see also *1-800-Got-Junk? L.L.C. v. Superior Court*, 189 Cal. App. 4th 500 (Cal. App. 2d Dist. 2010).

<sup>56</sup> Coldwell, D.S., *Issues to Consider in Bringing or Defending Franchise and Dealer Termination Litigation*, American Bar Association, The Antitrust Source (January 2005), available at [http://www.americanbar.org/publications/the\\_antitrust\\_source/past\\_issues.html](http://www.americanbar.org/publications/the_antitrust_source/past_issues.html) (last visited August 8, 2012).

*Business is, or will be, located, without regard to the laws of such state relating to conflicts of laws or choice of law; except that the provisions of any law of that state regarding franchises (including, without limitation, registration, disclosure, or relationship, and the regulations thereunder) shall not apply unless such state's jurisdictional, definitional and other requirements are met independently of, and without reference to, this Section.*

**c. Does the Example of an Overly Complicated Provision Accomplish the Purpose for Which it was Intended?**

This choice of law provision probably accomplishes the primary purpose for which it is intended. However, it does so using quite a bit of excess verbiage and confused, and poor drafting. The relevant question is whether such excess language is needed to accomplish this purpose or whether it is just extra baggage making the provision unreadable to anyone without a law degree. In this case, too many words create a risk that a court may decide that the parties did not intend the choice of law provision to be broadly interpreted. In addition, this provision has been corrupted by the inclusion of items better addressed in other provisions. Take for example the following: “this Agreement (including any claims, counter-claims or otherwise by you and/or any affiliate or yours) and all other matters concerning you (and/or any affiliate of yours) and us (and/or any affiliate of ours), and/or you (and/or any affiliate of yours) and any of the Franchisor-Related Persons/Entities, including your/our/their respective rights and obligations, will be governed by . . .” That is 65 words. The drafter can accomplish the same effect by writing “this Agreement and any and all disputes arising out of or related to this Agreement.” The excess words might well have a better home in the dispute resolution provision.

It is important to consider a more detailed choice of law provision in a franchise agreement.<sup>57</sup> The detail helps ensure that the parties' expectations have been addressed in the provision. Moreover, carefully considering the effects of a choice of law provision—and drafting to address the most significant of those effects—can help to ensure better predictability when it comes to choice of law.

In considering how to craft a choice of law provision effectively, one should be mindful of a few key points. As noted above, in the event a franchisor elects to arbitrate its disputes, the drafter should consider including a reference to the applicability of the Federal Arbitration Act (9 U.S.C. § 1 *et seq.*) along with the United States Trademark Law of 1946 (Lanham Act, 15 U.S.C. § 1050 *et seq.*). Obviously, such reference would be unnecessary if the franchisor elects to have disputes resolved by the state/federal judiciary system. In addition, issues of state franchise law should be carefully considered; however, there is no need to include language that accounts for state franchise laws that prohibit the use of choice of law provisions—so called anti-waiver statutes—so long as any such language is included in an addendum to the franchise agreement that addresses specific issues involving the franchisee's home state, the state in which the franchised business will be located or the state where the offer to sell or agreement to buy occurs.

Some drafters make the mistake of not including a separate choice of law provision opting rather to include a choice of law clause in the dispute resolution or arbitration section. Arguably, dispute resolution is the most likely place where the parties' choice of law may come

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<sup>57</sup> See Dady, J.M. et al., *Franchise Agreements: How Complicated Do They Need to Be?*, ABA Forum on Franchising (2007).

into play, but ill-advised placement of the choice of law selection may serve to unnecessarily narrow the effect of the provision. A court might narrowly construe a choice of law provision embedded in the ADR provision to mean that it only provides the substantive law to be applied in the arbitration, thus rendering it inapplicable to other sections of the agreement including any covenant not to compete.

Even in the face of state law prohibiting any choice of law provision, franchisors may be wise to include a broad choice of law provision allocable to all aspects of the agreement. Courts have sometimes enforced choice of law provisions despite a state franchise statute prohibiting it when the choice of law provision has little or no effect on the protection afforded to the franchisee by the state franchise law.<sup>58</sup>

**d. What is an Example of a Simpler Provision?**

*Except to the extent this Agreement or any particular dispute is governed by the United States Trademark Act, Federal Arbitration Act and other federal laws, this Agreement and any and all disputes, arising out of or related to this Agreement, directly or indirectly, shall be governed by and construed in accordance with the laws of the State of Montana (without reference to its conflict of laws principles), excluding any franchise law regulating the registration, disclosure or relationship between a franchisor and franchisee, which currently exist or may be adopted by the State of Montana shall not apply, unless the jurisdictional requirements of such laws are met independently without reference to this section. References to any law or regulation refer also to any successor laws or regulations or any published regulations for any statute, as in effect at the relevant time.*

**e. Does the Example of a Simpler Provision Accomplish the Purpose for Which it was Intended?**

The above referenced provision accomplishes the purpose for which it is intended for a variety of reasons. First, it sets forth the application of the law the parties intended to apply to any interpretation of the agreement, and in the event of a dispute, in simple and concise terms. Second, it addresses some of the issues that lay at the heart of many challenges attacking choice of law provisions, such as (a) the application of federal laws, (b) the application of state franchise and business relationship laws, and (c) general conflict of law principles. At the same time, it is not overburdened with an endless array of such possibilities. While one may decide to add more — by no means is the above provision the gold standard—keep in mind that the more specifics that are added the more likely it is that a court may decide the parties did not intend to have the law of the state chosen apply in a broad and all-encompassing manner. Deciding to what degree the choice of law provision applies to the parties' relationship, including any limitations, should be a conscious choice, not one made by inadvertent omission or over-inclusion.<sup>59</sup>

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<sup>58</sup> See *Tele-Save Merch. Co. v. Consumers Distrib. Co.*, 814 F.2d 1120, 1123 (6th Cir. 1987) (noting that critical question is whether choice of law substantially eroded the “quality of protection” the franchise statute would otherwise provide); *Cottman Transmission Sys., Inc. v. Melody*, 869 F. Supp. 1180, 1186 (E.D. Pa. 1994) (finding that enforcement of choice of law provision would not negatively impact the franchise law protections).

<sup>59</sup> See Olson, K. et al., *The Annotated Franchise Agreement*, ABA Forum on Franchising, at 84 (2010).



## **2. Forum Selection and Venue**

### **a. What is the Purpose of the Provision?**

A forum selection provision allows the parties to agree that any dispute related to the franchise agreement must be initiated in a specific forum. Forum selection provisions commonly include the issues of jurisdiction and venue. For franchisors, forum selection and venue provisions may be a way of creating some measure of “home court advantage.” Many franchisors draft the provision to provide for a forum in the franchisor’s home state.<sup>60</sup> This attempt can, however, be thwarted by state franchise statutes that void clauses that require a forum outside of the franchisee’s home state.<sup>61</sup> Typically, there is no need to include language that accounts for state franchise laws that prohibit the use of choice of venue provisions because any such language would be contained in an addendum to the franchise agreement.

### **b. What is an Example of an Under Drafted Provision?**

The following is an example of an under-drafted forum selection provision:

*“The exclusive forum for any litigation hereunder shall be the state or federal courts located in Cumberland County, State of New Mexico. Each Party irrevocably submits to the exclusive jurisdiction of such courts.”*

### **c. Does the Example of an Under Drafted Provision Accomplish the Purpose for which it was Intended?**

While a forum selection and venue clause will indeed be short, there are a few issues that need to be addressed. This provision does not accomplish the purpose for which it is intended for several reasons. First, it does not contemplate or mention personal jurisdiction and defenses related thereto. The parties' irrevocable submission to the exclusive jurisdiction of such court, may be effective, but it is not clear. Second, it does not contemplate the commencement of actions in other jurisdictions, if necessary, to enforce any future judgment or order.

### **d. What is an Example of a Well Drafted Provision?**

*Jurisdiction and Venue. Franchisee acknowledges and agrees that this Agreement is entered into in X County, X, and that any action to be brought by either party, arising out of or related to this Agreement, directly or indirectly, will be brought in the appropriate state court located in X County, X or in the United States District Court located in X. The Parties do hereby waive all defenses and questions of personal jurisdiction or venue for the purposes of carrying out this provision. The foregoing choice of jurisdiction and venue does not preclude the bringing of any action by the Parties for the enforcement of any judgment or order obtained in any such jurisdiction, in any other appropriate jurisdiction.*

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<sup>60</sup> Olson et al., at 85.

<sup>61</sup> See, e.g., Mich. Comp. Laws § 445.1527(f) (West 2004); see also Cal. Bus. & Prof. Code §20040.5 (1994) (“A provision in a franchise agreement restricting venue to a forum outside this state is void with respect to any claim arising under or relating to a franchise agreement involving a franchise business operating within this state.”).

**e. Does the Example of a Well Drafted Provision Accomplish the Purpose for which it was Intended?**

The above referenced provision accomplishes the purpose for which it is intended by clearly and concisely selecting a venue for disputes and pro-actively addressing the issue of jurisdiction over the parties in the event of a dispute arising out of the franchise agreement. In addition, it addresses the possibility that another forum may become necessary for the enforcement of a judgment obtained in the selected jurisdiction.

Forum selection clauses have been held enforceable if they are reasonable given the circumstances of the case.<sup>62</sup> Such clauses can be used to the drafter's advantage. By selecting a forum in the same state as its corporate headquarters, a franchisor may gain a variety of cost related advantages in the event of a dispute with a franchisee, including the reduction of travel expenses, the close proximity to most material franchisor witnesses and business records, and the elimination of the need to retain local counsel in a foreign jurisdiction.<sup>63</sup> While, choosing a forum near the franchisor's corporate headquarters, may not seem like a major financial savings for a franchisor in a relatively small regional system, it is undoubtedly the case for larger or more complex systems. Large systems with thousands of franchisees would see the most significant cost savings by being able to take advantage of economies of scale when considering the volume of disputes over a period of years.

In addition, an established forum may have significant expertise in the area of franchise law or, in the case of larger franchise systems, the local judges may become familiar with the franchise agreement and company over a period of years. Any combination of these factors can help a franchisor create the "home court advantage." Despite the effects of state anti-waiver provisions and some court decisions raising questions about the enforceability of forum-selection clauses<sup>64</sup>, like home court advantage in the sports context, most of the time there can still be substantial benefit to having disputes resolved in the franchisor's back yard.

Finally, as noted with choice of law provisions, it is a common mistake is to include a venue and forum selection provision within the franchise agreement arbitration provision specifically, but then omit it in the agreement as a whole. This can become important when trying to obtain injunctive relief and/or in instances where the arbitration provision is challenged and/or overturned.

**XI. ALTERNATIVE DISPUTE RESOLUTION**

**A. What is the Purpose of the Provision?**

The purpose of alternate dispute resolution ("ADR") provisions is to memorialize the agreement of the parties to utilize non-litigation procedures to resolve any disputes that may arise between them in the future. While there are many different forms of ADR, neither the style

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<sup>62</sup> *Stewart Org., Inc. v. Ricoh Corp.*, 487 U.S. 22 (1988) (holding that forum-selection clause is one factor in determining whether to grant transfer under 28 U.S.C. 1404(a); bargaining power of the parties, forum convenience, and fairness of transfer are other factors to be considered); see also Olson et al., at 85.

<sup>63</sup> See Section XI regarding alternative dispute resolution provisions in which the drafter attempts to achieve the same thing within the ADR provision.

<sup>64</sup> See *Kubis & Perszyk Assocs., Inc. v. Sun Micro Sys., Inc.*, 146 N.J. 176 (holding unenforceable as against public policy a clause selecting a California forum despite there being no anti-waiver statute in New Jersey).

nor the form nor the function is ever “one size fits all.” There are scores of Franchise Law Journal Articles and American Bar Association Forum on Franchising presentations that do an excellent job of describing the pros and cons of the various types of ADR,<sup>65</sup> discussing the drafting of arbitration provisions,<sup>66</sup> and discussing whether or not arbitration is really more desirable than traditional litigation.<sup>67</sup> For this program, we will only be exploring provisions that call for mediation and arbitration.

There are many benefits to finding an alternative to litigation. With mediation for example, the parties have the potential ability to craft a solution without a solution being forced upon them. There is a greater potential for reconciliation and restoration of the parties’ business relationship—an outcome less likely after an all-out litigation battle. Arbitration has become a common form of dispute resolution due to a long-held belief that litigation is the most expensive and time consuming form of dispute resolution. However, arbitration has seen so-called “judicialization” when arbitrations include extensive prehearing discovery and motion practice, making arbitrations more and more costly and time consuming.<sup>68</sup>

Consistency and predictability are definitely at the heart of any well-drafted mediation/arbitration provision. The drafter should endeavor to recognize the needs of the franchisor and the franchise system, and to provide the appropriate flexibility and cost effectiveness each franchise system needs. However, one size does not fit all when it comes to ADR provisions. Some very large franchise systems have extraordinarily sophisticated processes for resolving disputes. With the sheer volume of franchisees and the inevitable disputes that arise year over year, it may in fact be critical for a large system to develop essentially an internal judicial system that can streamline the process and provide predictability to franchisor and the many franchisees. In contrast, small or more regional franchise systems may have little need for a more complex structure. Regardless of the avenue taken by the franchise system, the provision should be as clear as possible.

An effective ADR provision should attempt to address several issues that may arise in the context of a franchise dispute. Thus, while being clear, concise and understandable, the following is probably too minimal in most cases:

Alternate Dispute Resolution - Prior to commencing litigation/arbitration, the Parties agree to submit any dispute arising under this Agreement to non-binding mediation conducted in [insert desired geographic location]. In the event the Parties are unable to resolve any such dispute in mediation, then the Parties agree to submit any such disputes to arbitration conducted in accordance with

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<sup>65</sup> See, e.g., Henry, J.F. et al., *Alternative Dispute Resolution in Franchise Systems*, ABA Forum on Franchising (1992); Miller, C. & Pressman, A., *The Darker Side of ADR*, ABA Forum on Franchising (1995); Dunham, E.W. & Lockerby, M.J., *Shall We Arbitrate? The Pros and Cons of Arbitrating Franchise Disputes*, ABA Forum on Franchising (2005).

<sup>66</sup> Carter, P. & Heller, B., *Navigating Nagrapma: Drafting and Contesting the Arbitration Clause*, ABA Forum on Franchising (2007).

<sup>67</sup> Lusthaus, J.C. et al., *Is Franchising Abandoning Arbitrations? Current Trends in Arbitrating Franchise Disputes*, ABA Forum on Franchising (2009).

<sup>68</sup> *Id.* at 9; see also Deborah R. Hensler, *Our Courts, Ourselves: How the Alternative Dispute Resolution Movement Is Re-Shaping Our Legal System*, 108 Pa. St. L.R. 165, 182 (2003).

the American Arbitration Association's Commercial Rules of Arbitration in [insert desired geographic location].

This provision needs more. First, the phrase "any dispute arising under this Agreement" can be narrowly construed versus a phrase such as "any and all disputes arising under or relating to this Agreement, directly or indirectly".<sup>69</sup> Second, it fails to consider the practical considerations associated with conducting mediation or arbitration in place of litigation. For example, by requiring the parties to conduct mediation before arbitration and not including time lines, it creates the possibility that the offending party can use the mediation-before-arbitration mandate to delay the process to the detriment of the other party. Third, it fails to include a jury waiver provision<sup>70</sup> or a provision reserving the franchisor's right to seek injunctive relief, which may create procedural challenges if it desires to do so.<sup>71</sup> Lastly, it does not grant the arbitrator the power to award reasonable attorneys' fees and costs to the franchisor or the prevailing party. There are many other procedural considerations. When arbitration and mediation are being used, the parties may well want a very detailed provision to ensure that they know exactly what kind of proceeding will, if necessary, take place.

In this section, there are two sample ADR provisions. The first provision is as comprehensive as it could possibly be. It is not poorly drafted; however, in most contexts it is overly complicated. In providing the second ADR provision, the authors hope to demonstrate a reasonable ADR provision that addresses several of the issues that arise most often in the context of a franchise dispute. Finally, this section will not fully address the relative pros and cons of having an arbitration or mediation provision at all. Arbitration and mediation clauses are optional and there may be circumstances in which it is not desired. More than any other provision, when drafting an arbitration/mediation provision, getting the advice of an experienced litigator may be valuable.<sup>72</sup>

## **B. What is an Example of an Overly Complicated Provision?**

### **1. Mediation and Mandatory Binding Arbitration, Waiver of Right to Trial by Jury.**

*Realizing that in business relationships there's always a possibility of differences of opinion or other disagreements and that what is most important is to resolve any disputes amicably, quickly, inexpensively and professionally and to return to business as soon as possible, it's with that same spirit of cooperation that you and we pledge to resolve differences and to use the procedures specified in this Agreement (and particularly this Article), believing that these procedures will reduce instances of possible disputes and make the resolution of any disputes which do arise less expensive, quicker, less subject to public notoriety and achievable in a less formal and antagonistic means than litigation, as well as to increase the opportunities*

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<sup>69</sup> See *Cape Flattery, Ltd. v. Titan Mar, L.L.C.*, 647 F.3d 914 (9th Cir. 2011) (holding that a tort claim independent of the contract itself was not arbitrable where the arbitration provision used "arising under" language rather than the broader "arising under or relating to" language).

<sup>70</sup> Courts have found jury-waiver provisions valid and enforceable in the context of a franchise agreement. See, e.g., *Aamco Trans., Inc. v. Harris*, No. 89-5533, 1990 U.S. Dist. LEXIS 7387 (E.D. Pa. 1990).

<sup>71</sup> See Abell, M. et al., *Avoiding and Managing System-Wide Litigation in International Franchising*, 26th Annual IBA/IFA Joint Conference, May 19, 2010, at 13.

<sup>72</sup> Carden & Klarfeld, at 5.

for you and us to maintain a mutually beneficial business relationship. Therefore, you and we agree as follows:

**a.** Any litigation, claim, dispute, suit, action, controversy, proceeding or otherwise ("claim") between or involving you (and/or any owner and/or affiliate of yours or which could be brought by, or on behalf of, you, any owner and/or affiliate of yours) and us (and/or any claim against or involving any or all of the Franchisor-Related Persons/Entities or otherwise), except as expressly provided below in Sub-section (e), whether arising out of or relating in any way to this and/or any other agreement and/or any other document, any alleged breach of any duty or otherwise (including but not limited to the underlying legality of the offer and/or sale of any franchise, any action for rescission or other setting aside of such sale or any transaction, agreement or document and any claim that this Agreement or any portion thereof is invalid, illegal, void, unenforceable or otherwise and any claim of fraud, including fraud in the Inducement) and on whatever theory and/or facts based, will be:

**i.** First, discussed in a face-to-face meeting between you (or, if the Franchisee is a corporation or partnership, an individual authorized to make binding commitments on behalf of the Franchisee) and a corporate executive of ours authorized to make binding commitments on our behalf. This meeting will be held at our then-current headquarters, or other location at our sole and absolute discretion and within 30 days after either you or we give written notice to the other proposing such a meeting.

**ii.** Second, if, in the opinion of either you or us, the meeting has not successfully resolved such matters and if desired by any person or entity involved in the claim, submitted to non-binding mediation for a minimum of eight hours before (a) Franchise Arbitration and Mediation, Inc. ("FAM") or its successor (or an organization designated by FAM or its successor) or (b) any other mediation organization approved by all such persons and/or entities or (c) by Judicial Arbitration and Mediation Service (JAMS) or its successor (or an organization designated by JAMS or its successor) if FAM cannot conduct such mediation and the parties cannot agree on a mediation organization. On election by any party, arbitration and/or any other remedy allowed by this Agreement may proceed forward at the same time as mediation. In the mediation, you and we shall each be represented by an individual authorized to make binding commitments on each party's respective behalf and may be represented by counsel. In addition, you and/or we may, with permission of the mediator, bring such additional persons as are needed to respond to questions, contribute information and participate in the negotiations. The mediator shall be disqualified as a witness, consultant, expert or counsel for any party with respect to the dispute and any related matters.

**iii.** Third, if neither you nor we desire mediation (or if such mediation is not successful in resolving such claim), submitted to and finally resolved by binding arbitration before and in accordance with the arbitration rules of FAM or its successor (or an organization designated by FAM or its successor); provided that if such arbitration is unable to be heard by FAM or its successor for any reason, the arbitration will be conducted before and in accordance with the arbitration rules of Judicial Arbitration and Mediation Service (JAMS) or its successor (or an organization designated by JAMS or its successor). In each case, the parties to any mediation/arbitration will execute appropriate confidentiality agreements, excepting only such public disclosures and filings as are required by law.

**b.** Any mediation/arbitration (and any appeal of arbitration) will be exclusively conducted at our then-current headquarters (which may be at a different place than our present headquarters), to facilitate participation of important individuals and availability of

documents, etc. to the resolution of the matter, and by a mediator/arbitrator experienced in franchising.

You and we acknowledge the critical importance of a single source for decisions in arbitration (and in any court actions) to guide you and us, to eliminate the possibility of inconsistent decisions and awards which could adversely affect the uniform development and administration of the Franchised System and group of companies and to maximize the opportunity for the arbitrator to give due consideration to your and our ongoing practical business needs in this regard. Except as expressly provided below, the parties to any mediation or arbitration will bear their own costs, including attorney's fees. Any claim, and any mediation/arbitration, will be conducted and resolved on an individual basis only and not on a class-wide, multiple plaintiff or similar basis. On request of any party to a claim, the arbitrator may be required to issue a written award, specifying the facts found and the law applied, but the party so requesting will bear the fees and charges incurred in connection therewith. The arbitrator (and any arbitration appeal panel) shall follow and apply all applicable law and a failure to do so shall be deemed an act in excess of authority. The arbitrator may award or otherwise provide for temporary restraining orders, preliminary injunctions, injunctions, attachments, claim and delivery proceedings, temporary protective orders, receiverships and other pre-judgment, equitable and/or interim relief as appropriate pending final resolution by binding arbitration of a claim, as well as in connection with any such final resolution, and may issue summary orders disposing of all or part of a claim at any point. Each party consents to the enforcement of such orders, injunctions, etc. by any court having jurisdiction. In any arbitration, any and all pre-trial discovery devices (including, but not limited to, depositions, written interrogatories, requests for admission, and requests for production, inspection and copying of documents) will be available to the disputants as if the subject matter of the arbitration were pending in a civil action before a court of general jurisdiction in the state whose law is to be applied under Section X of this Agreement; provided however that, in no event may offers and/or other communications made in connection with, or related in any way to, possible settlement or other resolution of a dispute be admitted into evidence or otherwise used in connection with any arbitration or other proceeding, and any arbitration award in violation of this provision shall be vacated by the arbitration appeal panel (described below) and/or any court having jurisdiction. The subpoena powers of the arbitrator with respect to witnesses to appear at the arbitration proceeding shall not be subject to any geographical limitation. The arbitrator shall have the power to order compliance with such discovery procedures, as well as assess sanctions for non-compliance with any order. The arbitrator (rather than a court) shall decide any questions relating in any way to the parties' agreement (or claimed agreement) to arbitrate, including but not limited to applicability, subject matter, timeliness, scope, remedies, claimed unconscionability and any alleged fraud in the inducement, or otherwise. Each participant must submit or file any claim which would constitute a compulsory counterclaim (as defined by the applicable rule under the Federal Rules of Civil Procedure) within the same proceeding as the claim to which it relates. Any such claim which is not submitted or filed in such proceeding will be forever barred.

The fees and expenses of the mediator(s), arbitrator(s), mediation organization and/or arbitration organization shall be shared equally by the parties to the dispute; provided that in any mediation, arbitration and/or any court proceeding, where a party seeks monetary relief and/or compensation, or recession, the first party who seeks such relief shall, on initiating such a mediation, arbitration or court proceeding [or (if later) on requesting such relief] deposit \$10,000 (subject to adjustment for inflation) with such organization (and/or with the court) to cover the costs and fees charged (or to be charged) by such mediation and/or arbitration organization and/or any costs recoverable in a court proceeding, but, in any case, not including any

attorney's fees. If such party does not receive substantially all of its initial demand in mediation, or does not prevail in such arbitration or court proceeding, such party shall bear all fees and costs charged by the mediating and/or arbitrating organization, and/or any costs recoverable in a court proceeding, but, in any case, not including any attorney's fees. In the event that any provision of this Section (or any other portion of this Agreement) is invalid or unenforceable, such provision will be construed as independent of, and severable from, every other provision and such provision will be modified or interpreted to the minimum extent necessary to have it comply with the law (including making such provision mutual in effect) and the remaining provisions will remain in full force and effect.

**c.** If any party to an arbitration wishes to appeal any final award by an arbitrator (there will be no appeal of interim awards or other interim relief), that party can appeal, within thirty (30) days of such final award, to a three (3) arbitrator panel to be appointed by the same organization as conducted the arbitration, such panel to conduct all proceedings at the same location as specified in subsection (b) above. The issues on appeal will be limited to the proper application of the law to the facts found at the arbitration and will not include any trial de novo or other fact-finding function. The party requesting such appeal must pay all costs and fees charged by such arbitration appeal panel and/or arbitration organization in connection with such appeal, as well as posting any bond deemed appropriate by such arbitration organization or arbitration appeal panel. In addition, a party requesting appeal, and who does not prevail on appeal, will pay the other party's (or parties') attorneys' fees and other costs of responding to such appeal.

**d.** Judgment on any preliminary or final arbitration award (subject to the opportunity for appeal as contemplated above) may be entered in any court having jurisdiction and will be binding, final and non-appealable.

**e.** Disputes with respect to claims or issues relating primarily to (i) the validity of the Marks or other intellectual property licensed to you, or (ii) any disputant's rights to possession of any real and/or personal property (including any action in unlawful detainer, ejectment or otherwise) shall be subject to court proceedings only.

**f.** Notwithstanding any provisions of this Agreement or otherwise relating to which state or provincial laws this Agreement will be governed by and construed under, all issues relating to arbitrability and/or the enforcement of the agreement to arbitrate contained herein will be decided by the arbitrator (including all claims that this Agreement in general, and/or the within agreement to arbitrate, was procured by fraud in the inducement or otherwise) and will be governed by the Federal Arbitration Act (9 U.S.C. § 1 et seq.) and the federal common law of arbitration. Notwithstanding any provisions of state law to the contrary, we intend to fully enforce the provisions of this franchise agreement and other documents, including all venue, choice-of-laws and mediation/arbitration provisions, and to rely on federal preemption under the Federal Arbitration Act (9 U.S.C. § 1 et seq.).

**g.** You and we each knowingly waive all rights to trial by a court or jury, understanding that arbitration may be less formal than a court or jury trial, may use different rules of procedure and evidence and that appeal is generally less available, still strongly preferring (for the reasons set forth in this section and the following one) mediation and/or arbitration to resolve any disputes, except as provided in Sub-section X.

**C. Does the Example of an Overly Complicated Provision Accomplish the Purpose for Which it was Intended?**

The well-placed desire for detail and comprehensiveness is how we get to the very long provision above. From a technical perspective, it is well written. Undoubtedly some of the specific provisions (i.e. the timeline, jury waiver provision, selection of the arbitrator) will prove to be helpful and time- saving devices should a dispute arise among the parties. This ADR section provides a detailed road map to resolving disputes of any kind that may arise between the parties. In some cases, all of this verbiage and detail may be desired by the franchisor to accomplish the goals of an ADR provision. In the case of the franchise system with thousands of franchisees, it may in the best interest of both franchisee and franchisor for there to be a detailed approach and process for the resolution of disputes. For example, in the provision above, the franchisee must attend a face-to-face meeting at the outset to be located at the franchisor's headquarters or at a location to be selected by the franchisor. In addition, any arbitration will be held at the franchisor's then-current headquarters. In the case of a very large, national, franchisor, such a provision, while clearly providing benefits to the franchisor, would also allow for the faster and more efficient resolution of a franchisee's disputes. After all, there may be hundreds of small disputes. It would not be cost effective or time-saving for a large franchisor to have to travel to each franchise location.

A more streamlined and simpler provision may prove just as effective. In the context of a smaller franchise system, such a detailed provision may suffer from a severe case of over-diagnosis.

**D. What is an Example of a Simpler Provision?**

**1. Alternate Dispute Resolution**

**a. Mediation**

*THE PARTIES AGREE TO ATTEMPT TO RESOLVE ANY AND ALL DISPUTES ARISING OUT OF OR RELATING TO THIS AGREEMENT BY NON-BINDING MEDIATION IN [INSERT GEOGRAPHIC LOCATION], CONDUCTED BY A SINGLE MEDIATOR, NO LATER THAN 90 DAYS AFTER THE COMMENCEMENT OF ANY LITIGATION OR ARBITRATION. EITHER PARTY MAY COMMENCE THE MEDIATION PROCESS BY PROVIDING TO THE OTHER PARTY WRITTEN NOTICE, PURSUANT TO SECTION X, SETTING FORTH THE SUBJECT OF THE DISPUTE, CLAIM OR CONTROVERSY AND THE RELIEF REQUESTED. WITHIN 10 DAYS AFTER THE RECEIPT OF THE FOREGOING NOTICE, THE OTHER PARTY WILL DELIVER A WRITTEN RESPONSE TO THE INITIATING PARTY'S NOTICE. THE INITIAL MEDIATION SESSION WILL BE HELD WITHIN 90 DAYS AFTER THE INITIAL NOTICE. THE PARTIES AGREE TO SHARE EQUALLY THE COSTS AND EXPENSES OF THE MEDIATION (WHICH SHALL NOT INCLUDE THE EXPENSES INCURRED BY EACH PARTY FOR ITS OWN LEGAL REPRESENTATION IN CONNECTION WITH THE MEDIATION) THE MEDIATOR WILL BE AGREED UPON BY THE PARTIES WITHIN 30 DAYS AFTER THE INITIAL NOTICE. IF THE PARTIES DO NOT OR ARE NOT ABLE TO AGREE UPON A MEDIATOR WITHIN 30 DAYS AFTER THE INITIAL NOTICE, THEN THE FRANCHISOR WILL HAVE THE RIGHT TO SELECT THE MEDIATOR.*

*THE PARTIES FURTHER ACKNOWLEDGE THAT MEDIATION PROCEEDINGS ARE SETTLEMENT NEGOTIATIONS, AND THAT, TO THE EXTENT ALLOWED BY APPLICABLE LAW, ALL OFFERS, PROMISES, CONDUCT AND STATEMENTS, WHETHER ORAL OR*



WRITTEN, MADE IN THE COURSE OF THE MEDIATION BY ANY OF THE PARTIES OR THEIR AGENTS WILL BE CONFIDENTIAL AND INADMISSIBLE IN ANY ARBITRATION, LITIGATION OR OTHER LEGAL PROCEEDING INVOLVING THE PARTIES; PROVIDED, HOWEVER, THAT EVIDENCE WHICH IS OTHERWISE ADMISSIBLE OR DISCOVERABLE WILL NOT BE RENDERED INADMISSIBLE OR NON-DISCOVERABLE AS A RESULT OF ITS USE IN THE MEDIATION.

**b. Arbitration**

ANY AND ALL DISPUTES, ARISING OUT OF OR RELATED TO THIS AGREEMENT, WILL BE SETTLED BY ARBITRATION UNDER THE FEDERAL ARBITRATION ACT, AS AMENDED, IN ACCORDANCE WITH THE COMMERCIAL ARBITRATION RULES OF THE AMERICAN ARBITRATION ASSOCIATION OR ANY SUCCESSOR BODY THERETO, BEFORE A SINGLE ARBITRATOR AGREED UPON BY THE PARTIES. EITHER PARTY MAY DEMAND TO SUBMIT A CLAIM TO ARBITRATION BY SENDING WRITTEN NOTICE IN ACCORDANCE WITH SECTION X. IF THE PARTIES ARE UNABLE TO AGREE UPON AN ARBITRATOR WITHIN 30 DAYS OF RECEIPT OF SUCH NOTICE, THEN EITHER PARTY MAY PETITION THE X COUNTY COURT IN THE STATE OF X OR THE UNITED STATES DISTRICT COURT LOCATED IN X FOR THE APPOINTMENT OF AN ARBITRATOR IN ACCORDANCE WITH THE FEDERAL ARBITRATION ACT OR ANY SUCCESSOR LAW. SUCH ARBITRATION WILL BE CONDUCTED IN X PURSUANT TO THE EXPEDITED PROCEDURES OF THE COMMERCIAL ARBITRATION RULES OF THE AMERICAN ARBITRATION ASSOCIATION, OR SUCH OTHER PROCEDURES AS MAY BE MUTUALLY AGREEABLE TO THE PARTIES. ANY DETERMINATION MADE THEREIN WILL BE FINAL AND BINDING ON EACH AND ALL THE PARTIES THERETO AND THEIR SUCCESSORS AND ASSIGNS AND JUDGMENT THEREIN MAY BE ENTERED BY ANY COURT OF COMPETENT JURISDICTION. THE ARBITRATOR MAY ALSO AWARD ATTORNEY FEES AS SET FORTH IN SECTION X. THE ARBITRATOR WILL HAVE CONTINUING JURISDICTION TO IMPLEMENT HIS/HER DECISION.

THE PARTIES HEREBY CONSENT TO THE ABOVE-MENTIONED ARBITRATOR'S JURISDICTION OVER EACH AND EVERY ONE OF THEM. FRANCHISEE ACKNOWLEDGES AND AGREES THAT IT IS THE INTENT OF THE PARTIES THAT ARBITRATION BETWEEN FRANCHISOR AND FRANCHISEE WILL BE OF FRANCHISOR'S AND FRANCHISEE'S INDIVIDUAL CLAIMS, AND THAT NONE OF FRANCHISEE'S CLAIMS WILL BE ARBITRATED ON A CLASS-WIDE BASIS.

FRANCHISEE EXPRESSLY ACKNOWLEDGES THAT FRANCHISEE HAS READ THE TERMS OF THIS BINDING ARBITRATION PROVISION AND SPECIFICALLY AFFIRMS THAT THIS PROVISION IS ENTERED INTO WILLINGLY AND VOLUNTARILY AND WITHOUT ANY FRAUD, DURESS OR UNDUE INFLUENCE ON THE PART OF FRANCHISOR OR ANY OF FRANCHISOR'S AGENTS OR EMPLOYEES.

MOREOVER, FRANCHISEE ACKNOWLEDGES THAT, NOTWITHSTANDING ANY CONTRARY LANGUAGE IN THIS AGREEMENT OR FRANCHISOR'S FRANCHISE DISCLOSURE DOCUMENT, THE FEDERAL ARBITRATION ACT PREEMPTS ANY STATE LAW RESTRICTIONS ON THE ENFORCEMENT OF THE ARBITRATION CLAUSE IN THIS AGREEMENT ACCORDING TO ITS TERMS, INCLUDING ANY RESTRICTIONS ON THE SITE OF THE ARBITRATION.

**c. Waiver of Jury Trial**

FRANCHISEE AND FRANCHISOR EACH IRREVOCABLY WAIVE TRIAL BY JURY IN ANY ACTION, WHETHER AT LAW OR EQUITY, BROUGHT BY EITHER OF THEM.

**d. Injunctive Relief**

NOTWITHSTANDING THE ARBITRATION CLAUSE IN SECTION X, FRANCHISOR MAY BRING AN ACTION FOR INJUNCTIVE RELIEF IN ANY COURT HAVING JURISDICTION TO ENFORCE THE FRANCHISOR'S NON-COMPETITION, TRADEMARK, AND/OR PROPRIETARY RIGHTS, IN ORDER TO AVOID IRREPARABLE HARM TO THE FRANCHISOR, ITS AFFILIATES, OR THE FRANCHISE SYSTEM AS A WHOLE.

**E. Does the Example of a Simpler Provision Accomplish the Purpose for Which it was Intended?**

The above is an example of an ADR provision that arguably balances the goals of being clear, concise and understandable, while at the same time giving due consideration to a myriad of procedural and substantive issues that are likely to arise: First, the mediation provision provides for a procedural framework, but it also does not make mediation a prerequisite to the commencement of arbitration or litigation. If mediation is a prerequisite, as noted above, a party may be able to use this arrangement to affect a procedural delay. In addition, injunctive relief is sometimes indicated and a mediation provision should most certainly not prevent a franchisor from seeking an injunction without first going through mediation.

Second, the arbitration provision sets forth a framework for commencing arbitration touching upon areas such as (i) location of the arbitration; (ii) timing; (iii) selection of the arbitrator; and (iv) the arbitrator's ability to award attorney's fees. The arbitrator's authority stems from the contract between the parties so it is important for the parties to provide the arbitrator with the appropriate tools to resolve the dispute within the format.<sup>73</sup> There has been recent debate regarding the use of delegation clauses in which the arbitration agreement language purports to grant to the arbitrator the exclusive authority to determine the existence, validity, or enforceability of the arbitration clause.<sup>74</sup> In *Rent-A-Center, West, Inc. v. Jackson*,<sup>75</sup> the Supreme Court held that if the validity of the entire arbitration agreement is being challenged, then the arbitrator decides the unconscionability question; if, however, the challenge is targeted to a specific provision delegating enforceability questions to the arbitrator, the court decides the unconscionability question. *Rent-A-Center* confirmed that delegation provisions can be enforced. However, the court did not close off the possibility of a successful challenge to a delegation clause within an arbitration provision.

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<sup>73</sup> Arbitrator awards may be vacated by the courts "where the arbitrators exceed their powers." Federal Arbitration Act, 9 U.S.C. § 10(a)(4).

<sup>74</sup> See generally Karen Halverson Cross, *Letting the Arbitrator Decide Unconscionability Challenges*, 20 Ohio St. J. on Dispute Resolution 1 (2011). Unconscionability challenges arise when a party to a contract that the mere existence of the arbitration clause prevents any prospective plaintiff from having their "day in court." See *Krisian v. Comcast Corp.*, 446 F.3d 25, 37 (1st Cir. 2006) (holding that arbitration that prevents plaintiffs from vindicating their rights is not a "valid alternative to traditional litigation.").

<sup>75</sup> 130 S. Ct. 2772 (2010).

Third, the ADR provision contains a jury trial waiver clause and provides for an exception to arbitration for injunctive relief where appropriate. These two subsections are important. Jury waiver may be a benefit of arbitration should such avoidance be desired by the parties, particularly the franchisor. Such jury avoidance is automatic when a dispute is submitted to arbitration, but in the event a dispute is held to be not arbitrable for whatever reason, and proceeds in the courts, the independent and conspicuous jury trial waiver may become valuable.<sup>76</sup> Yet, even when the franchisor is availing itself of the perceived benefits of arbitration, including jury avoidance, it is important to draft a carve out from the arbitration provision that allows for injunctive relief lest the franchisor be left with a holdover franchisee who can use and abuse the franchise system and, in particular, the system's proprietary information and intellectual property while the franchisor must wait for an enforceable arbitration decision (which is no guarantee).<sup>77</sup>

Fourth, the example specifically prohibits class arbitration. In *Green Tree Financial Corp. v. Bazzle*<sup>78</sup>, the Supreme Court held that without an express prohibition on class proceedings in the agreement to arbitrate, the arbitrator could decide whether an arbitration should proceed as a class action. Commentators quickly urged franchisors to strongly consider such an express prohibition if desired.<sup>79</sup> In the wake of *Bazzle*, a Circuit split developed on the question of whether a class arbitration could proceed in the face of silence on the issue in the agreement.<sup>80</sup> In 2010, in *Stolt-Nielsen SA v. AnimalFeeds Int'l Corp.*, 130 S. Ct. 1758 (2010), the Supreme Court held that imposing class arbitration on parties who had not agreed to authorize class arbitration was inconsistent with the Federal Arbitration Act. An agreement to authorize class arbitration is “not a term that the arbitrator may infer solely from the fact of an agreement to arbitrate.” While the *Stolt-Nielsen* decision indicates that an express prohibition is not necessary to prevent class arbitration, an express prohibition is a clearer expression of the intentions of the parties.

There are numerous details that can be addressed in an ADR provision. These provisions can be as intricate as the parties desire. The size and sophistication of the system will dictate the extent of the detail regarding procedure and should be duly considered when drafting an ADR provision. The above example of a simpler provision is merely to provide an example and is by no means intended to be sufficient for all situations. ADR provisions are optional, and while the options are endless, there are several important considerations that many years of precedent and experience have revealed.

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<sup>76</sup> Some consideration must be given to the placement of these provisions. A court may take a tough stance on whether the jury-waiver provision was conspicuous enough. If the court determines the provision is hidden, it can rule that the waiver was not knowing and voluntary. See, e.g., *Samica Enters., L.L.C. v. Mail Boxes Etc. USA, Inc.*, 637 F. Supp. 2d 712 (C.D. Cal. 2008); but see, *Aamco Trans., Inc.*, No. 89-5533, 1990 U.S. Dist LEXIS 7387 (E.D. Pa. 1990) (finding that jury waiver was conspicuous because the print was small, but uniform throughout the agreement and the placement of the jury waiver clause was logical and unsurprising).

<sup>77</sup> Such carve-out provisions are common in franchise agreements and generally upheld. Carden & Klarfeld, at 10 (citing *Peabody Coalsales Co. v. Tampa Elec. Co.*, 36 F.3d 46 (8th Cir. 1994)).

<sup>78</sup> *Green Tree Fin. Corp. v. Bazzle*, 539 U.S. 444 (2003).

<sup>79</sup> See, e.g., Carden & Klarfeld, at 7.

<sup>80</sup> In *Bazzle*, the parties had disagreed as to whether the agreement was silent on the issue of class arbitration.

## XII. INTEGRATION CLAUSE

### A. What is the Purpose of the Provision?

An integration clause exists to make clear that the franchise agreement represents the franchisor and franchisee's entire agreement and that it supersedes all other informal understandings and agreements, written or verbal, relating to the franchise agreement. In addition, an integration clause may also serve to delineate what information the parties were and were not relying upon when they executed the franchise agreement. Drafters of franchise agreements may accomplish this by stating that the franchise agreement "supersedes all prior representations . . ." or by including language that clearly disclaims making any representation other than what is in the four corners of the agreement.<sup>81</sup> Additionally, more specific no-reliance language is sometimes seen in a separate section conspicuously highlighted in some way (similar to warranty disclaimers in other contexts), but there is no correct location. In many commercial agreements, an integration clause appears under the label "miscellaneous" and it often lives with several other standard provisions. In drafting an integration clause in a franchise agreement, it is important to give due consideration to the reason for including an integration clause, including any applicable disclaimers of the representations in the franchise disclosure documents, rather than simply assuming the closest available boilerplate language will suffice.<sup>82</sup>

At the core, integration clauses directly affect whether the parol evidence rule will apply or whether extrinsic evidence may be introduced in the event of a dispute over what the parties promised each other.<sup>83</sup> Thus, when crafting a provision that says that the franchise agreement is the only agreement on the subject between the parties, it is helpful if such provision is written in as clearly and expressly as one can muster. Legalese doesn't necessarily make a provision more clear; it only makes it more likely that a lawyer was involved. Words like "[t]his Agreement and the documents referred to herein" are ripe for confusion down the road. What documents are attached to the franchise agreement? Are they exhibits, schedules, side-letters, etc.? If there is an accompanying promissory note, is that part of the agreement? This type of language creates an opportunity for a disgruntled franchisee to argue that it relied on a document presented by the franchisor that was attached to the franchise agreement at the time of the closing, e.g. a side letter, and this provision does not give the franchisor the ability to forcefully close the door on that type of argument. If the provision is not clear as to what is or is not included in the Agreement, it could create a textbook ambiguity that could allow a disgruntled franchisee the ability to muddy the waters as to what the agreement really was.

Even without ambiguity, an ill-conceived integration clause or a misunderstanding about its effect and/or application can be problematic. In *Brennan v. Carvel*<sup>84</sup>, the First Circuit

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<sup>81</sup> See Carden, D.L. and Klarfeld, P.J., "We Have To Live With It" – Tips From the Litigators' Perspective on Advanced Drafting, ABA Forum on Franchising (2005).

<sup>82</sup> See also Maslyn, P. et al., *Franchise Agreement Drafting*, Int'l Franchise Ass'n, 38th Annual Legal Symposium (2005) ("Despite that it is typically buried deep in the 'Miscellaneous' section of a franchise agreement, the integration clause – at least from a litigation perspective – arguably is the most important provision in a franchise agreement.")

<sup>83</sup> See Olson et al., *The Annotated Franchise Agreement*, ABA Forum on Franchising, at 84 (2010); see also Coldwell, D.S. et al., *Litigating "The Contract": The Evolution of the Integration Clause and the Parol Evidence Rule in Franchise and Distribution Cases*, ABA Forum on Franchising (2005).

<sup>84</sup> *Brennan v. Carvel Corp.*, 929 F.2d 801 (1st Cir. 1991).

examined whether an integration clause in a franchise agreement superseded a written contract between franchisor and franchisee regarding selection of a suitable location. Citing the collateral agreement rule,<sup>85</sup> the court found that, under Massachusetts law, the determination of whether a second contract was collateral to an integrated agreement was a question of fact to be decided by the trial judge.<sup>86</sup> The court held that the agreement to assist the franchisee in selection of a suitable location was a collateral agreement. The court noted that the franchise agreement was silent as to site location and selection, but Carvel's disclosure statement specifically stated that the franchisor would have the responsibility for selecting a suitable location.<sup>87</sup> Thus, this second agreement was not integrated into the franchise agreement, and the franchisee was entitled to sue for an alleged breach of that agreement.

In contrast, in an attempt to make sure no door is left open, drafters may overreach in stating that the franchise agreement the "only agreement." A provision might state that the agreement "constitutes the entire agreement of the parties and supersedes and cancels any and all prior and contemporaneous agreements . . ." The use of the word "contemporaneous" may be overbroad because most franchise agreements are executed at the same time as other agreements, such as guarantees, lease riders, etc. Did the drafter of this provision really mean to cancel those agreements? Probably not, but the language creates an unnecessary ambiguity which is precisely what the drafter is trying to avoid.

Finally, drafters sometimes separately include language regarding modification in the franchise agreement. Such a clause simply states that no modifications or amendments shall be made unless by a writing authorized and signed by the parties. Some consideration should be given to including this language with the integration clause. The no-modification language serves a similar purpose.<sup>88</sup> By stating clearly that no modifications or amendments of the agreement are effective without an additional signed writing, the parties are reaffirming that, without any such additional writings, the franchisee agreement represents the full extent of the parties' relationship.

## **B. What is an Example of an Overly Complicated Provision?**

*You and we, each agreeing on the critical practical business importance of our relationship being governed solely by written documents signed by you and us (including any concurrently executed written personal guarantees, Statement of Prospective Franchisee and/or exhibits - schedules - addenda - promissory note(s) - security agreement(s) or other written documents signed by the party to be bound thereby, all of which will be deemed to be part of this Agreement for the purposes of this Section X) and not wishing to create misunderstandings, confusion and possible conflict through reference to any alleged prior and/or contemporaneous oral and/or written representations, understandings, agreements or otherwise or any legal doctrines such as: "good faith and fair dealing" or otherwise which might introduce an element of uncertainty into our relationship, jointly intend, represent, warrant and agree that (1) this Agreement contains the final, complete and exclusive expression of the terms of your and our*

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<sup>85</sup> "[T]he fact that an agreement is completely integrated does not, of course, affect an attempt to show an entirely separate and distinct agreement between the same parties." *Id.* at 807.

<sup>86</sup> *Id.*

<sup>87</sup> *Id.*

<sup>88</sup> Olson, at 98.

agreement, and the final, complete and exclusive expression of your and our intent, and entirely supersedes and replaces any and all prior and/or concurrent understandings, agreements, inducements, prior course(s) of dealing, representations (financial or otherwise), promises, options, rights-of-first refusal, guarantees, warranties (express or implied) or otherwise (whether oral or written) between you and us, (2) there are no prior and/or concurrent understandings, agreements, inducements, course(s) of dealing, representations (financial or otherwise), promises, options, rights-of-first refusal, guarantees, warranties (express or implied) or otherwise (whether oral or written) which are not fully expressed in this Agreement and (3) no prior and/or concurrent understandings, agreements, inducements, course(s) of dealing, representations (financial or otherwise), promises, options, rights-of-first refusal, guarantees, warranties (express or implied) or otherwise (whether oral or written) of any kind or nature whatsoever have been made by us or anyone else, nor have been relied on by you nor will have any force or effect; excepting only the written representations made by you in connection with its application for this franchise. You and we each expressly disclaim any understandings, agreements, inducements, course(s) of dealing, representations (financial or otherwise), promises, options, rights-of-first refusal, guarantees, warranties (express or implied) or otherwise (whether oral or written) which are not fully expressed in writing in this Agreement. This is equally important to you, as well as us, since, just as we do not wish to deal with allegations that we may have made or entered into understandings, representations, etc. not fully expressed in writing in this Agreement (such as alleged earnings claims), you do not wish to deal with allegations that you made or entered into understandings, representations, etc. (such as promises to achieve particular sales or royalty payment levels, would open a particular number of units, etc.) which are not fully expressed in writing in this Agreement.

In particular, we have not authorized, and you have not been promised, nor have we or anyone else made, nor have you received or relied on, any promises, representations or warranties, that: (1) any payments by you are refundable at your option, (2) we will repurchase any rights granted hereunder (or any associated business) or be will able to assist you in any resale, (3) you will succeed in the franchised business, (4) you will achieve any particular sales, income or other levels of performance, (5) you will have any exclusive rights of any type other than as expressly set forth herein, (6) you will receive any level of advertising (television or otherwise), marketing assistance, site location, development or other services, operational assistance or otherwise other than as expressly set forth in this Agreement, (7) you will not be required to obtain any licenses in order to operate your Franchised Business, (8) any location will be successful, (9) it will be anyone's responsibility other than yours to obtain all licenses necessary in order to establish and operate your Franchised Business or (10) that you will be awarded additional or further franchises or other rights, except as expressly set forth in a written document signed by a corporate officer of the Franchisor. No contingency, condition, prerequisite, prior requirement, or otherwise (including but not limited to obtaining financing, obtaining a site or otherwise) exists with respect to you fully performing any or all of your obligations under this Agreement.

You have not received or relied on (nor have we or anyone else provided) any oral or written: sales, income or other historical results, projections or otherwise, of any kind or nature or any statements, representations, data, charts, tables, spreadsheets or mathematical calculations or otherwise which stated or suggested any level or range of actual or potential sales, costs, income, expenses, profits, cash flow, tax effects or otherwise and neither we nor anyone else has made, nor have you relied on, any promises, representations or warranties as to any profits you may realize in the operation of your Franchised Business, nor have you received or relied on any representations regarding any working capital or other funds necessary to reach any "break-even" or any other financial level. We can't reliably predict.

*forecast or project future performance, revenues, profits or otherwise of any [insert concept name], even including one owned and/or operated by us. due to the large number of factors outside our control, and we certainly can't reliably predict what your results might be. You understand that results will vary from unit to unit. If any such information, promises, representations and/or warranties has been provided to you, they haven't been authorized, they should not be relied on, we will not be bound by them, and, if you do rely on such information, promises, representations and/or warranties, you do so at your own risk.*

**C. Does the Example of an Overly Complicated Provision Accomplish the Purpose for Which it was Intended?**

This provision is not necessarily poorly drafted. It accomplishes the general purpose for which it was drafted. And, it does an excellent job of trying to forecast potential issues in the event of a dispute. In addition, it painstakingly explains the representation disclaimers. However, there is significant excess verbiage that makes reading it—and thus understanding it—potentially difficult. Again, with this integration clause, the franchisor is asking the franchisee, one final time, to make sure that he or she is aware of the risks surrounding the business as presented in the franchise disclosure document and to accept the franchise on the terms of the franchise agreement. For this provision, clarity is of utmost importance. This provision also expressly disclaims any representations not included in the franchise agreement. Such disclaimers will not always bar claims against the franchisor for alleged fraudulent activity depending on the public policy for the applicable state.<sup>89</sup> Additionally, state statutes may also prohibit unfair trade practices.<sup>90</sup> However, integration clauses have been found to successfully eliminate claims, including fraud, outside of the writing.<sup>91</sup>

**D. What is an Example of a Simpler Provision?**

**Entire Agreement.**

*This Agreement, including all exhibits schedules, and/or other attached documents will be construed together and constitute the entire agreement between Franchisor and Franchisee concerning the subject matter of this Agreement, and will supersede all prior agreements between the parties, whether written or oral. No other or additional representations have induced Franchisee to execute this Agreement, and there are no representations, inducements, promises or agreements, oral or otherwise, between the parties not specifically embodied within this Agreement, which are of any force or effect with reference to this Agreement or otherwise. No amendment, change, or variance from this Agreement will be binding on either party unless executed in writing by both parties. Nothing in this Agreement, or in any related agreement is intended to disclaim the representations made in the Franchise Disclosure Document that Franchisor provided to the Franchisee.*

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<sup>89</sup> See *Nathan's Famous Sys., Inc. v. Phylli Foods, Inc.*, Bus. Franchise Guide (CCH) ¶ 11,281 (Sup. Ct. Nass. Cty. 1997) (holding that New York Franchise Act prohibited franchisors from requiring franchisees to assent to a release or waiver that would relieve a person from liability imposed by statute).

<sup>90</sup> See, e.g., Mass. Gen. L. Ann. ch. 93A.

<sup>91</sup> *Scoggins v. Snap-On Tools Int'l*, CCH Bus. Franchise Guide ¶ 10,203 (N.D. Ala. 1993) (precluding franchisee's fraud claim based on representations outside the agreement).

### **E. Does the Example of a Simpler Provision Accomplish the Purpose for Which it was Intended?**

This integration provision accomplishes the purpose for which the provision was intended by addressing the issues noted above. There is no shortage of solutions to drafting this provision. This example seeks to demonstrate one way in which the issues that arise around these agreements can be addressed without overkill. Some may prefer a more cautious and all-encompassing approach. Some drafters may prefer to include specific franchisee representations and warranties (as demonstrated in the “overly complicated” integration clause above). For example, the provision might contain a clause stating that franchisee represents that it has entered into the agreement after independent investigation of the franchisor’s operations and the franchise system.<sup>92</sup> Despite the fact that integration clauses are often considered boilerplate, a clearly and concisely written integration clause that thoughtfully addresses a variety of issues that commonly arise in franchise disputes, can prevent a great deal of heartburn in the future.

### **XIII. CONCLUSION**

Drafting franchise agreements is challenging in part because of the length of the term of many franchise contracts. Because the parties are likely to be in a legal relationship governed by the terms of the franchise agreement for a long period of time, drafting clear provisions is of the utmost importance. As one court noted:

“. . . the starting point of any contractual analysis is the language of the contract itself. [footnote omitted]. In interpreting a contract our overriding concern is to give effect to the intent of the parties. [citation omitted]. If a contract is clear and unambiguous we must determine the intention of the parties 'solely from the plain language of the contract' and may not consider extrinsic evidence outside the 'four corners' of the document itself. [emphasis added].<sup>93</sup>

This review of certain franchise agreement provisions indicates that there are ways in which critical provisions can be “simplified” without sacrificing appropriate consideration of case law and statutory requirements. The simple provisions included are not necessarily shorter than the overly complicated provisions, but they tend to use clearer language and more active verbs and are written in a concise fashion. The overly complicated provisions are often wordy, repetitive, full of “legalese”, written in the passive voice, and based on cumbersome drafting. The point for any franchise system is to strike the right balance so that franchise agreements accurately reflect the rights and obligations of the franchisee and franchisor but do so in a way that is clear and understandable to all parties.

An important lesson learned from this examination of franchise agreement provisions is that there is no “standard” language. The challenge for franchise attorneys is to work like that doctor who uses common sense to find simple and effective solutions while still looking out for the best interests of their patients - the franchisor and the integrity of the franchise system.

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<sup>92</sup> For this and other examples of specific representations and warranties that might be appropriate for inclusion in the integration provision, see Carden & Klarfeld, at 30.

<sup>93</sup> *McDonald's Corp. v. C.B. Mgmt. Co.*, 13 F. Supp. 2d 705, 709 (N.D. Ill. 1998).



## APPENDIX

### List of Sources on Drafting Franchise Agreement

The following sources offer detailed guidance on drafting issues and case precedent for Franchise Agreements.

1. Asbill, R., Goldman, S. and Klarfeld, P., *Drafting Franchise Agreements so that Duties are Defined by the Parties Rather than Courts or Arbitrators*, program materials for 1998 ABA Forum on Franchising (1998).
2. Carden, D. and Klarfeld, P., *We Have to Live With It – Tips from Litigators' Perspective on Advanced Drafting*, program materials for 2005 ABA Forum on Franchising (2005).
3. Dady, J.M., Kaufmann, D. and Wall, S., *Franchise Agreements: How Complicated Do They Need to Be?*, program materials for 2007 ABA Forum on Franchising (2007).
4. Fittante, Jr., J. and Wieczorek, D., *Advanced Drafting*, program materials for 2004 ABA Forum on Franchising (2004).
5. Glenn, R.D., *Drafting Franchise Agreements in California*, Chapter 2 of California Franchise Law and Practice 2011, Continuing Education of the Bar, California.
6. Goodhard, K., Lambert, K. and Pitegoff, T., *Laying the Keel: Drafting Effective Franchise Agreements*, program materials for 1992 ABA Annual Forum on Franchising (1992).
7. Olson, K., Spencer, R. and Weinberg, L., *The Annotated Franchise Agreement*, program materials for 2010 ABA Forum on Franchising (2010).
8. Rudnick, L. and Weaver, D., *Can a Franchise Agreement be Both Fair and Effective?*, program materials for 1991 ABA Forum on Franchising (1991).

## BIOGRAPHIES

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