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ANCILLARY AGREEMENTS: THE OTHER CONTRACTS NEEDED IN THE FRANCHISE RELATIONSHIP

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ANCILLARY AGREEMENTS: THE OTHER CONTRACTS NEEDED IN THE FRANCHISE RELATIONSHIP

I. INTRODUCTION

At the heart of every franchise relationship is the franchise agreement. A franchise agreement defines the essential terms by which the franchisor and franchisee will act over the term of the franchise relationship. However, no franchise agreement can incorporate every term necessary to clearly define a successful relationship between the franchisor and franchisee over the life of the franchise. Many franchise agreements in use today are very lengthy, driven by the franchisor's need to be clear in its expectations of the franchisee, as well as to build in needed flexibility to allow the business to change over time. Specific system standards are not included in most franchise agreements as franchise systems rely on their operations manual to incorporate current and future operating standards.

Most franchise systems therefore rely on a series of additional contracts to fully establish the rights and obligations of both the franchisor and franchisee over the life of the franchise agreement.[1] Some of these agreements arise at the formation of the franchise relationship but are not included in the franchise agreement as they involve third parties or would otherwise further expand an already lengthy franchise agreement. Other agreements are used during the term of the franchise relationship and are needed as the business evolves. There also are contracts customarily used to define each party's rights and obligations at the end of the franchise relationship.

When preparing ancillary agreements, one should keep in mind that, depending on the timing of when a franchisee (or prospective franchisee) is required to sign the agreement, the franchisor may need to attach the agreement to its Franchise Disclosure Document ("FDD"). Section 5 of the Federal Trade Commission Act (the "FTC Franchise Rule") requires franchisors to attach to the FDD "a copy of all proposed agreements regarding the franchise offering, including the franchise agreement and <u>any lease, options, and purchase agreements</u>"[2] (emphasis added). While the FTC Franchise Rule is not clear as to which agreements must be attached to the FDD, it is generally interpreted to require all agreements (between the franchisee and the franchisor or an affiliate of the franchisor) that a prospective franchisee is required to sign, has the option to sign, or commits to sign at or before the time of becoming a franchisee.

An additional word of caution is in order. As franchise systems evolve and use multiple ancillary agreements to further define the full relationship between the franchisor and its franchisees, the franchisor's lawyer must pay careful attention to the drafting of the ancillary agreements to ensure the terms of the agreements do not unintentionally contradict the terms of the franchise agreement. In particular, the drafter must make certain the choice of law, venue and dispute resolution provisions, among others, are consistent with similar provisions in the

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[1] *See also,* Nancy G. Gourley and David W. Koch, *The Other Contracts in the Franchise Relationship*, ABA 29th Annual Forum on Franchising (2006).

[2] 16 C.F.R. §436.5(v).

franchise agreement. When disputes arise under one or more of these agreements within a franchise relationship, courts must determine whether the agreements should be enforced separately under their own terms, or whether multiple agreements should be interpreted as one agreement. The drafting of each of the agreements in question will ultimately provide the court with direction in making this determination.

There are a number of cases in which the franchise agreement requires arbitration, but the ancillary agreement in question does not. Are the parties then required to arbitrate issues under the ancillary agreement, or can they bypass arbitration despite the fact that the ancillary agreement is really just one part of the entire relationship otherwise governed by the franchise agreement? Careful attention to drafting can eliminate these issues. Generally, the language of the arbitration clause will help determine the answer to this question. If the arbitration clause – typically found in the franchise agreement – requires arbitration of "any and all disputes" between the parties or of all disputes "arising out of or related to" the franchise agreement, the parties will be required to arbitrate disputes arising under ancillary agreements that do not contain an arbitration requirement.[3]

This paper will address many of the everyday ancillary agreements in use by franchise systems to fully define their franchise relationships. This is not an exhaustive study of every agreement in use, but rather, the paper will focus on those agreements most commonly used today. Additionally, the legal issues associated with most of the matters covered by these ancillary agreements are extensive and could be separate papers unto themselves (and in many cases have already been addressed in other papers or articles). To the extent possible, the authors will provide readers with resources for further analysis of issues related to the various types of agreements discussed in this paper.

II. ANCILLARY AGREEMENTS APPLICABLE TO THE INCEPTION OF THE FRANCHISE RELATIONSHIP AND ONGOING BUSINESS OF THE FRANCHISED BUSINESS

A. Letter of Intent and other Preliminary Agreements

1. Purpose

Other than the FDD, a letter of intent or other preliminary agreement is one of the first documents to be presented to a prospective franchisee. Generally, the purpose of a preliminary agreement is for both the franchisor and prospective franchisee to express their respective interest in entering into a new franchise agreement by undertaking to perform certain tasks or satisfy conditions in anticipation of a new franchise relationship. A preliminary agreement typically gives the prospective franchisee an opportunity to acquire a specific territory or location, obviously subject to the franchisor's approval. Preliminary agreements typically include various conditions that the prospective franchisee must satisfy before the franchisor will offer the prospective franchisee a franchise. The benefits of a preliminary agreement extend to both the prospective franchisee and the franchisor – it allows the prospective franchisee time to conduct its own due diligence and evaluation of the franchise, and also provides the franchisor with time to conduct preliminary credit and entity approvals. In addition, a preliminary

[3] Gourley, *supra* note 1 at 30; *See also Neal v. Hardee's Food Systems, Inc.*, 918 F.2d 34 (5th Cir. 1990), and *Glen W. West, Sr. v. Gen. Motors LLC*, No. 11-819(JAP), 2011 WL 3472337 (D.N.J. Aug. 5, 2011).

agreement can help move along the process of signing a definitive franchise agreement by setting out key dates, documents, and tasks for the prospective franchisee.

2. Important Terms

A preliminary agreement, which should be signed or acknowledged by the prospective franchisee, should clearly state that it is not a franchise agreement. The terms should include language that makes the conditional nature of the offer clear - that the franchisor is under no obligation to offer a franchise, and that the prospective franchisee must satisfy certain conditions and sign a separate franchise agreement.

A preliminary agreement also can include site selection criteria and set forth expectations regarding architectural and engineering plans. These are typically the same requirements and standards that are included in the franchisor's FDD or franchise agreement, but a preliminary agreement gives the franchisor a way to set forth any restrictions prior to entering into a binding franchise agreement. Frequently, a preliminary agreement will grant a prospective franchisee an exclusive right to locate a site for the franchised business within a certain area. This exclusive right is typically for a pre-determined period of time (e.g., 90 days) and the preliminary agreement expires automatically at the end of the period, or earlier if the parties enter into a franchise agreement.

Some franchisors charge a deposit or holding fee, which may or may not be refundable. The terms of the preliminary agreement should be clear as to whether or not the deposit or fee is refundable (in whole or in part) and whether the amount paid will apply to the initial franchise fee payable under a franchise agreement if the prospective franchisee is approved. The franchisor's or prospective franchisee's ability to terminate the preliminary agreement often is dependent on the nature of the deposit or holding fee payable under the agreement. Agreements where the deposit or fee is non-refundable may allow the prospective franchisee to terminate without cause at any time, while granting the franchisor the right to terminate only if certain milestones are not met (e.g., site selection within 90 days). However, preliminary agreements in which the deposit or fee is fully refundable may allow either party to terminate without cause at any time.

Finally, preliminary agreements should include a confidentiality provision and other boilerplate language (choice of law, costs and attorneys' fees, no waiver and consent to jurisdiction and venue). These standard provisions may protect a franchisor in disputes with prospective franchisees, and should not be overlooked. Although franchisors might not want to "scare off" prospective franchisees with a long agreement while the relationship is still in its early stages, franchisors should take the appropriate measures to protect themselves against the risks associated with such agreements.

3. Practical Considerations

Note that if the letter of intent or other preliminary agreement is legally binding on the prospective franchisee, or if it requires payment to the franchisor (e.g., a deposit or fee), the franchisor must comply with Section 436.2(a) of the FTC Franchise Rule[4], and disclose the prospective franchisee with the franchisor's FDD at least 14 calendar days before the prospective franchisee signs the preliminary agreement or makes payment. The preliminary

[4] 16 C.F.R. §436.2(a).

agreement can be drafted so that it will merge into a franchise agreement if the prospective franchisee is approved and the parties enter into a definitive franchise agreement.

As is the case with all agreements, it is important that the terms of a letter of intent or other preliminary agreement are clear and unambiguous. For example, in *Barnes & Robinson Co., Inc. v. OneSource Facility Services, Inc.*[5], the plaintiffs brought (among other claims) a breach of contract claim regarding letters of intent entered into with the franchisor. The plaintiffs alleged the letters did not require the signing of a franchise agreement, just that the parties come to an agreement, whether or not in writing. The court found that the letters of intent, in ordinary and common language, were not ambiguous in their intent, and affirmed the trial court's motion to dismiss the plaintiffs' complaint. Accordingly, the court held that "it is apparent the parties intended, and required, a signed written document…the Letters of Intent are riddled with terms indicating the parties intended to 'consider' a 'proposed purchase' or 'contemplated transaction' in anticipation of a final agreement between the parties."[6]

B. Confidentiality Agreements

1. Purpose

All franchise agreements should include confidentiality provisions that bind the franchisee and protect the franchisor's confidential information, trade secrets, the operations manual, and other proprietary materials disclosed during the franchise relationship; however, a franchisor also may want to consider requiring the execution of a confidentiality agreement in other situations, such as by the prospective franchisee and its owners before a franchise agreement is signed, or by certain employees of franchisees, or even by employees of the franchisor.

Franchisors have multiple options to choose from when deciding in which agreement to include the confidentiality covenants. In addition to including these covenants in the franchise agreement, franchisors can create a form of confidentiality agreement for their franchisees or their franchisees' owners and/or employees to sign, or they can include confidentiality covenants in the guaranty that the franchisees' owners are required to sign. The more important consideration is ensuring that everyone to whom a franchisor discloses its proprietary information, trade secrets, or other confidential information executes a confidentiality agreement.

2. Important Terms

Confidentiality covenants are vital to a franchise system. Therefore, franchisors should clearly define "confidential information" and make sure that the covenant is as strong and broad as possible. Whether a franchisor elects to include confidentiality covenants in its franchise agreement and/or in a separate standalone agreement, the confidentiality covenants must be broad enough to protect all of the franchisor's confidential information, regardless of whether the materials are marked as confidential or the means by which the information is disclosed (e.g., verbally, through the operations manual, or otherwise). Some franchisors choose to limit the duration of the confidentiality covenant (e.g., for a certain number of years after the franchise agreement expires or terminates). Franchisors who elect to do so must remember to exclude

[5] 195 S.W.3d 637 (Tenn.App. 2006).

[6] *Id.* at 642.

trade secrets from the limitation so that the confidentiality covenant with respect to trade secrets lasts indefinitely. Many franchisors also choose to use a standalone confidentiality agreement as an opportunity to impose other in-term and post-term covenants, such as non-solicitation and non-competition covenants on those persons who are not parties to the franchise agreement. (See Section II, E below for a discussion of non-competition and non-solicitation agreements).

3. **Practical Considerations**

The terms of a franchise agreement often require the individual owners of the franchisee (if the franchisee is a legal entity) to undertake confidentiality obligations. It is recommended, however, for a franchisor to require all parties to whom the franchisor discloses its proprietary information, trade secrets, or other confidential information to execute a confidentiality agreement. The timing as to when a confidentiality agreement should be signed largely depends on when a franchisor plans to disclose its confidential information to a prospective franchisee. For example, some franchisors choose to share their operations manual with prospective franchisees early in the franchise sales process, even before the prospective franchisee signs a franchise agreement. In such instances, franchisors should require, as a prerequisite to disclosure, that all persons receiving such information sign a confidentiality agreement. Another example can be seen in connection with initial training. Many franchisors permit multiple attendees to attend initial training where proprietary information and trade secrets are typically shared with attendees. Not all attendees may be a party to the franchise agreement, and, therefore, may not be bound by any confidentiality obligations. Again, in such instances, a franchisor should strongly consider requiring that all attendees of its initial training program sign a confidentiality agreement as a condition to attending training. Franchisors should be mindful that potential franchisees may feel uncomfortable signing any binding agreement at an early stage; nevertheless, franchisors need to consider the potential risks to their brand by not being able to enforce confidentiality obligations against such individuals.

It is worth noting that confidentiality agreements can be useful not just as a supplement to a franchise agreement to protect a franchisor's proprietary and confidential information and trade secrets; they also can serve as an independent evidentiary tool in litigation. In *Noble Roman's, Inc. v. French Baguette, LLC*[7], the court found that by executing a confidentiality agreement with the franchisor, the franchisee's owner had "personally availed himself of the privilege of conducting business in Indiana," which was one of a few factors in the court's decision to deny the franchisee owner's motion to dismiss.

C. **Franchisee Disclosure Questionnaire**

1. **Purpose**

In an effort to help reduce the risk of disgruntled franchisees bringing claims for improper sales practices and fraud, many franchisors require franchisees to sign, prior to the sale, a franchisee disclosure questionnaire in which the franchisee and its owners (if the franchisee is an entity) acknowledge that they understand the risks of opening and operating a franchise, no improper sales practices were committed, and no unlawful financial performance representations were made by the franchisor or its salespeople, agents, officers, and employees. Although some franchisors include these acknowledgements in the body of the franchise agreement, many franchisors choose to include the acknowledgements in a separate

[7] 684 F.Supp.2d 1065 (S.D. Ind. 2010).

questionnaire document to help avoid any argument by the franchisee that it was not aware of the acknowledgements.

2. Important Terms

Often times, franchisee disclosure questionnaires are drafted extremely broad in an effort to address the numerous fraud allegations disgruntled franchisees commonly raise in lawsuits against franchisors. While it may not be possible to include an acknowledgement or representation for every possible fraud allegation, at a minimum, a franchisee disclosure questionnaire should include the following acknowledgements by the franchisee and each of its owners (if the franchisee is an entity):

a. Each has independently investigated the franchise opportunity and recognizes that, like any other business, the nature of the business a [name of franchised outlet] conducts may, and probably will, evolve and change over time.

b. That an investment in a [name of franchised outlet] involves business risks that could result in the loss of a significant portion or all of the franchisee's (and its owners') investment.

c. That the franchisee's (and its owners') business abilities and efforts are vital to the franchised business's success.

d. That attracting customers for the franchisee's [name of franchised outlet] will require franchisee to make consistent marketing efforts in the franchisee's community through various methods, including media advertising, direct mail advertising, and display and use of in-store promotional materials.

e. That retaining customers for the franchisee's [name of franchised outlet] will require the franchisee to have a high level of customer service and adhere strictly to the franchise system and the franchisor's system standards and that the franchisee is committed to maintaining system standards.

f. That the franchisee (and its owners) have not received from the franchisor, and are not relying upon, any representations or guarantees, express or implied, as to the potential volume, sales, income, or profits of a [name of franchised outlet].

g. That in all of their dealings with the franchisee (and its owners), the franchisor's officers, directors, employees, and agents act only in a representative, and not in an individual, capacity and that business dealings between the franchisee (or its owners) and them as a result of the franchise agreement are deemed to be only between franchisee and franchisor.

h. That the franchisee has represented to the franchisor, to induce the franchisor's entry into the franchise agreement, that all statements the franchisee (and its owners) have made and all materials the franchisee (and its owners) have given the franchisor are accurate and complete and that the franchisee (and its owners) have made no misrepresentations or material omissions in obtaining the franchise.

i. That the franchisee (and its owners) have read the franchise agreement and the franchisor's FDD and understand and accept that the franchise agreement's

terms and covenants are reasonably necessary for the franchisor to maintain its high standards of quality and service, as well as the uniformity of those standards at each [name of franchised outlet], and to protect and preserve the goodwill of the franchisor's trademarks.

j. That the franchisor has the right to restrict the franchisee's sources of goods and services, as provided in various sections of the franchise agreement.

k. That the franchisor has not made any representation, warranty, or other claim regarding the [name of franchised outlet] franchise opportunity, other than those made in the franchise agreement and the franchisor's FDD, and that the franchisee (and its owners) have independently evaluated the opportunity, including by using their business professionals and advisors, and have relied solely upon those evaluations in deciding to enter into the franchise agreement.

l. That the franchisee (and its owners) have been afforded an opportunity to ask any questions they have and to review any materials of interest to the franchisee (or its owners) concerning the [name of franchised outlet] franchise opportunity.

m. That the franchisee (and its owners) have been afforded an opportunity, and have been encouraged by the franchisor, to have the franchise agreement and all other agreements and materials the franchisor has given or made available to the franchisee reviewed by an attorney and have either done so or waived their right to do so.

3. <u>Practical Considerations</u>

Whether one chooses to include franchisee acknowledgments in the body of the franchise agreement or in a separate franchisee disclosure questionnaire, it is strongly recommended that the franchisee be required to initial each of the acknowledgments (assuming it agrees with the representation) and, if the acknowledgments are included in a separate franchisee disclosure questionnaire, the franchisee be required to sign the questionnaire. In addition, some franchisors structure the questionnaire so that the acknowledgments are in a "yes or no" question format that the franchisee must complete prior to signing the questionnaire. The more actions that the franchisee is required to take with respect to the acknowledgments, the more difficult it will be for the franchisee to argue that it did not understand the acknowledgments.

Franchisee disclosure questionnaires have proven to be a valuable litigation document for franchisors. In 2011, a Wisconsin court[8], relying on the franchisor's franchisee disclosure questionnaire and acknowledgements made in the franchisor's other agreements, dismissed a franchisee's strict liability and negligent fraud claims against the franchisor. In this case, the franchisor, Cousins Subs, brought a lawsuit against one of its franchisees for breach of contract. The franchisee defendants counterclaimed, alleging Cousins induced the defendants to sign the contracts with fraudulent misrepresentations regarding personnel and potential profits. The franchisees had signed a franchisee disclosure questionnaire, which stated that each person had "discussed the benefits and risks of operating a Cousins Subs shop with an attorney, accountant, or other professional advisor," that they understood "the risks of operating a Cousins Sub Shop," and that "no representative of Cousins had made any statement or promise

[8] *Cousins Subs Systems Inc. v. Better Subs Development Inc.,* No. 09-C-0336, 2011 WL 4585541 (E.D. Wis. Sept. 30, 2011).

concerning the total amount of revenue the Cousins Subs will generate…or made any statement of the likelihood of success."[9] The court found that the franchisee disclosure questionnaire, along with similar language in the franchisor's disclosure document, and other agreements all "contained express provisions denying [the defendants'] ability to rely on the representations of financial data and other purported promises. To the extent that a representative of Cousins made a false representation of fact, [the defendants] could not rely on those statements by the express and very clear terms of [the franchisor's] documents."[10]

Franchisors should be cautious, however, of relying solely on a franchisee disclosure questionnaire and believing that such documents will eliminate all risks of fraud. At least one court has found that acknowledgment documents, such as a franchisee disclosure questionnaire, cannot be used as a defense to fraud claims under the state franchise laws. In *Emfore Corp. v. Blimpie Associates, Ltd., et al.*,[11] a New York appellate court disallowed the use of a questionnaire as a waiver of fraud claims under the New York Franchise Act because of the Act's anti-waiver provision. However, the court did uphold its dismissal of the franchisee's common-law fraud claims because "[t]he disclaimers were not generalized boilerplate exclusions, but were contained in a separate rider, which [the franchisee's] principal read and initialed, stating specifically that she was not relying on any representations by [the franchisor]."[12] While a franchisee disclosure questionnaire can help reduce fraud claims by disgruntled franchisees, because many states' franchise disclosure laws contain similar anti-waiver provisions as the anti-waiver provision under the New York Franchise Act, franchisors should be aware of the document's limitations.

D. Personal Guarantee

1. Purpose

Some franchise systems still enter into their franchise agreements with individuals. However, it is more common today that the franchisee is an entity formed by the individuals the franchisor has approved to operate the franchised business. A franchisor that allows its franchisees to operate their franchised business as a corporation, limited liability company, or partnership provides its franchisees with the opportunity to take advantage of the tax and liability protections offered by the various types of entities. While the franchisor will be able to pursue all of its rights in the franchise agreement against the franchisee entity, without obtaining personal guarantees from the individuals the franchisor originally approved to be its franchisee, the franchisor will not be able to pursue those individuals in the event of any breach of the franchise agreement by the franchisee. Most franchisors' decision to enter into a franchise agreement in the first place is based on a thorough review of the financial wherewithal and operating experience of the individuals. Accordingly, personal guarantees from these individuals are necessary to fully protect the franchisor in the event of a default.[13]

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[9] *Id.* at *3.

[10] *Id.* at *7.

[11] 51 A.D.3d 434 (N.Y. App. Div. 2008).

[12] *Id*. at 435.

[13] *See* Rupert M. Barkoff, *Traditional and Avant-Garde Uses of Personal Guarantees in Franchise Relationships*, 23 Franchise L.J., No. 3 (Winter 2004); *See also,* Charles S. Modell and Andrew C. Selden, *What Do Personal Guarantees Offer the Franchisor?*, 23 Franchise L.J. No. 3 (Winter 2004).

2. Important Terms

A guarantee without proper consideration may not withstand a challenge by the guarantor.[14] Therefore, personal guarantees should be drafted to clearly state that the consideration for the guarantor's entry into the guarantee is the franchisor's grant of the franchise to the franchisee. A clear statement of this consideration contained in the guarantee itself leaves no question about the presence and extent of consideration.[15]

The guarantee should extend not only to the financial obligations of the franchisee, but also to the performance obligations. The guarantee often covers any liabilities arising from third party claims (e.g., customers) as a result of the operation of the franchised business by the franchisee. It also can cover damages resulting from an early termination of the franchise agreement, including future royalty payments.

The term of the guarantee should be for the initial and all successor terms of the franchise agreement. All liability under the guarantee should be joint and several with the franchisee and any other guarantors. The terms of the guarantee should require guarantors to waive: (i) notice of nonperformance; (ii) that any action by the franchisor must be taken first against the franchisee or any other guarantor as a condition of the guarantor's liability; (iii) any right of subrogation or reimbursement from the franchisee; (iv) any law that requires the franchisor to proceed against the franchisee before taking action against the guarantor; and (v) any defenses the guarantor might have. The guarantee itself either should include the same choice of law and venue terms as contained in the franchise agreement, or, if the guarantee is an exhibit or addendum to the franchise agreement, it should specify the terms of the franchise agreement that are incorporated into the guarantee. For clarity sake, if the franchise agreement requires arbitration, drafters should consider including the same arbitration requirements in the guarantee.[16]

3. Practical Considerations

How does the franchisor decide who must sign a personal guarantee? If the franchisor is entering into a franchise agreement with one individual who has decided to operate its franchise business under a corporate entity, that question is easily answered as the franchisor will just require that individual to provide a guarantee. However, if assets belonging to the individual's spouse are included in the franchisor's financial evaluation of the prospective franchisee, the franchisor also should require the spouse to provide a personal guarantee whether or not the spouse will be actively involved in the franchised business.[17]

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[14] *Super 8 Worldwide, Inc. v. American Lodging Partners, Inc.,* 2011 U.S. Dist. LEXIS 7007 (N.D. Ill. Jan. 25, 2011) holding "A promise to benefit a third party constitutes sufficient consideration to bind the guarantor."

[15] *See Ingram Micro Inc. v. ABC Mgmt. Tech. Solutions, LLC,* 746 F.Supp.2d 765 (E.D. Va. 2010), upholding a personal guarantee that was clear and unambiguous that the defendant was personally liable for the debts of the company.

[16] *See Binder v. Medicine Shoppe Int'l., Inc.*, No. 09-14-46, Bus. Franchise Guide (CCH) ¶14,432 (E.D. Mich. July 20, 2010) holding guarantors were personally obligated to arbitrate even though the terms of the guarantee did not include an arbitration requirement but the franchise agreement did require arbitration.

[17] *But See Citgo Petroleum Corporation v. Bulk Petroleum Corporation, et.al,* Case No. 08-CV-654-TCK-PJC, 2010 U.S. Dist. LEXIS 106495 (N.D. Okla. Oct. 5, 2010), in which the court voided a guarantee required by the spouse of

What should the franchisor do if there are multiple owners of the franchise entity with varying levels of ownership interests? Many franchisors require personal guarantees from every owner, despite the percentage of ownership interest each holds. Other franchisors only require personal guarantees from owners with some defined level of ownership (e.g., more than 20% of the ownership interest in the franchisee entity). This decision depends on the franchisor's level of risk tolerance, the nature of the franchised business, the individuals involved in the franchisee's business, the extent of the financial assets held by each individual that the franchisor considered when approving the franchisee, and the level of involvement each individual will have in the day-to-day operations of the franchised business.

Franchisors also should consider whether or not they wish to secure the guarantees received with collateral of the individual guarantors. Perfecting a security interest in such collateral can help protect the franchisor in the event the guarantor files bankruptcy. To effectively create a perfected security interest, franchisors will need to obtain and record UCC-1 statements or mortgages on the applicable collateral used as security.

A separate form of guarantee is recommended. Often, franchisors attempt to save paper and time by requiring that the franchisee entity's officers and owners sign the franchise agreement under an acknowledgment on the signature page indicating that they agree to be bound by the terms of the franchise agreement. Yet these individuals are not parties to the franchise agreement. At least one franchisor has found this manner of attempting to secure guarantees from the franchisee's principals to be ineffective. In *Medicine Shoppe International, Inc. v. Anick, Inc., et al.*[18], the court found that "for an instrument to be enforceable as a guaranty, it must show the guarantor's intent to be liable on an obligation in case of default by the principal promisor".[19] The acknowledgment at issue in this Medicine Shoppe case read in part: "the undersigned agree… that they, and each of them, shall be firmly bound by all of the terms, provisions and conditions of the foregoing".[20] The court found that the language used by Medicine Shoppe did not meet the requirement to serve as a guarantee and therefore the court dismissed Medicine Shoppe's claims against one of the individuals thought to be a guarantor.

E. Non-Competition and Non-Solicitation Agreements

1. Purpose

Non-competition and non-solicitation covenants are used to protect the franchisor's interests in its trademarks, trade secrets, system standards, and other confidential information.[21] By preventing franchisees and their principals and key employees from using these interests of the franchisor outside of the rights granted in the franchise agreement, the franchisor can preserve its goodwill and market share, and protect the integrity of its marks.[22] The franchise

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the guarantor based on a violation of the Equal Credit Opportunity Act which prohibits creditors from requiring the spouse of a guarantor from providing a guarantee when the guarantor itself is individually creditworthy.

[18] No. 4:09CV277 FRB, 2010 U.S. Dist. LEXIS 78431 (Aug. 4, 2010).

[19] *Id.* at *10.

[20] *Id.* at *6.

[21] *See Covenants Against Competition in Franchise Agreements* (Peter J. Klarfeld ed., 2d ed. 2003).

[22] Jason M. Murray and Michael R. Gray, *The Enforcement of Covenants Against Competition*, ABA 28th Annual Forum on Franchising (2005).

agreement will typically include well-drafted covenants against any in-term and post-term competition or solicitation by the franchisee. Some franchise agreements expressly extend these covenants to all of the franchisee's principals who are signatories to the franchise agreement. But if the franchise agreement does not provide for this, separate non-competition and non-solicitation agreements should be obtained from all of the franchisee's principals. Additionally, there are typically other individuals within the franchisee's organization that will have access to and knowledge of the franchisor's proprietary and confidential information. The franchisor also should require that the franchisee obtain non-competition and non-solicitation agreements from certain key employees of the franchisee and should require the franchisee to maintain a log of all such signed agreements that can be provided to the franchisor upon the franchisor's request.

Non-solicitation covenants are typically included in non-competition agreements where the business operated by the franchise system relies on customer information to drive the success of each franchised business. A post-term non-solicitation covenant will restrict the franchisee, its principals, and its key employees from soliciting customers served during the term of the franchise agreement for a certain period of time after the expiration or termination of the franchise agreement. The non-solicitation covenant is important to protect the franchise system as a whole in the event a franchisee, principal or key employee leaves the system and wishes to continue his or her involvement in a similar business.

2. Important Terms

Effective non-competition and non-solicitation agreements are based on protecting a franchisor's legitimate interests, but are subject to a standard of reasonableness. Courts will generally find non-competition covenants in franchise or related agreements to be valid and enforceable if they meet four criteria.[23] Courts will examine if the non-competition covenants are: (i) ancillary to an enforceable contract; (ii) given in exchange for valuable consideration; (iii) reasonable in both time and territory to protect the franchisor's interest; and (iv) not against public policy.[24] To ensure a franchisor can enforce a non-competition covenant, careful attention to the drafting of the covenant is needed because courts are generally reluctant to enforce non-competition covenants that are too broad or place unnecessary constraints on a party.

The non-competition and non-solicitation agreement should clearly articulate the specific interests the franchisor is attempting to protect. Depending on the franchisor's system, this may include such interests as customer relationships, proprietary items (such as recipes or product formulations), trade secrets, vendor relationships, encroachment, or use of confidential information.

As is the case with all agreements, adequate consideration is essential. Accordingly, the non-competition and non-solicitation covenants should articulate the consideration received by the party subject to such covenants. This can include a statement that the signatory, by virtue of his or her position with the franchisee, will have access to the franchisor's trade secrets and confidential information and will be receiving valuable training on the franchisor's proprietary

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[23] *Id.* at 2.

[24] *Id.*, *See also* Peter J. Klarfeld and Mark S. VanderBroek, *Law on Covenants Against Competition Shifts Toward Greater Enforceability by Franchisors*, 31 Franchise L.J. 2 (2011).

system. Franchisors should use the same definition for "confidential information" in both its franchise agreement and any separate non-competition and non-solicitation agreements in order to avoid the possibility for ambiguity.

The agreement must state the time period covered by the non-competition and non-solicitation covenant. It also must address the geography in which the franchisee may not compete or solicit customers within this time period. To be deemed reasonable, a franchisor must determine the appropriate amount of time and geographical scope the franchisor needs to reasonably protect its legitimate interests. Additionally, the non-competition agreement should be reasonable in the activity it restricts. For example, prohibiting a quick service restaurant franchisee from operating any type of restaurant likely will be considered to be unreasonable. The enforceability of any post-term non-competition and non-solicitation agreement will be jeopardized by a franchisor's attempt to enforce a covenant that is too broad in scope, particularly in time, geography, or activity.[25] While courts in some states are permitted to "blue pencil" a non-competition or non-solicitation covenant to reduce either its time or geographical scope to a time or scope deemed enforceable, other courts are not. States in which courts are not permitted to "blue pencil" will find the non-competition or non-solicitation covenant to be void and unenforceable if it is determined to be too broad in scope (time or geography).[26] To enable a court to modify the scope of a non-competition and non-solicitation agreement, the agreement also should contain a severability clause.

If the franchisor requires individuals that are not a party to the franchise agreement to execute a non-competition and non-solicitation agreement, the non-competition and non-solicitation covenants should not be more restrictive than the same provisions contained in the franchise agreement. The franchisor is not always a party to non-competition and non-solicitation agreements required under the franchise agreement. Sometimes the agreement is between the franchisee and its employee; however, the franchisor also must have the right to enforce the terms of each agreement directly against their signatories. If the franchisor is not a party to the agreement, such agreement should specifically make the franchisor a third party beneficiary to the agreement with the right to enforce the terms of the agreement directly against the signatories.

As franchisors will want to enforce any violation of a non-competition or non-solicitation covenant by pursuing injunctive relief to stop the violation, these agreements must clearly provide the franchisor with the right to pursue injunctive relief in an event of a breach by any of the signatories to the agreement. If the franchise agreement provides that disputes between the parties will be resolved through arbitration, the arbitration language should exclude violations resulting from any breaches of the non-competition and non-solicitation covenants in both the franchise agreement and the ancillary non-competition and non-solicitation agreements, and permit the franchisor to pursue injunctive relief in court.

The validity of a non-solicitation covenant is generally analyzed using the same criteria as used to determine the validity of a non-competition covenant. Therefore, drafters also should be mindful of the same issues as discussed above regarding non-competition covenants. Additionally, there may be situations where a franchisee or any of its principals or key

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[25] *See* Murray, *supra* at note 23 for a more extensive discussion on time and geographical restrictions.

[26] *See Victory Lane Quick Oil Change, Inc. v. John P. Hoss, et al.,* No. 07-14463, 2010 U.S. Dist. LEXIS 16441 (E.D. Mich. Feb. 24, 2010), where the court found the non-compete to be unenforceable as it was not tailored to protect the franchisor's business interests.

employees had relationships with customers prior to the franchisee entering into the franchise agreement with the franchisor. These existing customer relationships should be noted and carved out of the non-solicitation provisions.

3. Practical Considerations

Certain states have specific franchise statutes that address the enforceability of non-competition covenants against franchisees, and other states have general non-competition statutes that may be applicable to franchising.[27] In preparing a non-competition and non-solicitation agreement for execution, franchisors must be aware of these laws and the resulting enforceability of these covenants in those states. While carefully determining the best choice of law provision to include in their franchise agreement and non-competition and non-solicitation agreements is necessary, this may not prevent a non-competition or non-solicitation covenant from being found unenforceable in certain states.[28]

There is considerable case law addressing the issue of in-term and post-term competition by parties related to the franchisee or its principals.[29] Frequently, spouses or children operate competing businesses in the same market that would clearly be subject to the non-competition covenant terms if operated by the franchisee or a principal; however, these individuals typically are not parties to the franchisor's non-competition and non-solicitation agreements. Franchisors have argued that the terms of the non-competition covenant should extend to these individuals, even though they were not signatories to the non-competition and non-solicitation agreement. Some courts have extended the reach of a non-competition covenant to non-signatories if the party operating the competing business had a close relationship to the franchisee or principal.[30] While franchisors should carefully consider the appropriate parties required to execute a non-competition and non-solicitation agreement, it is not practical to ask all individuals related to the franchisee or its principals to sign such agreements. Franchisors may be able to take some comfort in knowing that courts have found that certain individuals who were not signatories to a non-competition and non-solicitation agreement are subject to the agreement's covenants if the franchisor can show that the individual has knowledge of the covenants and is using the former franchisee's knowledge or skill to operate the competing business.

F. Loan Documents – Promissory Note, Security Agreement, Loan Agreement

1. Purpose

In today's financial climate franchisors may offer a variety of creative financing programs to potential and existing franchisees, including purchase money financing and construction loans. Franchisors may offer financing to help with the development of new outlets or to assist existing franchisees' to meet their obligations to refresh existing outlets upon renewal or as otherwise required under the franchise agreement. Financing programs offered by franchisors can vary from simple loans evidenced by a promissory note and loan agreement to more

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[27] *See* Murray *supra* note 23 at 10.

[28] *See Covenants Against Competition, supra* note 22.

[29] *See* Murray *supra* note 23.

[30] *Id.* at 18.

complex loan structures that include documents such as a loan agreement, guaranty, promissory note, mortgage or deed of trust for real property, and secured by a security agreement and/or UCC-1 filing for personal or business property. Generally, the loan documents under a franchisor's loan program are similar to the loan documents in connection with a loan from a traditional lender; the loan agreement sets forth the terms of the loan, including the loan amount, purpose of the loan (e.g., for the construction of a facility), amortization, disbursement, and default; the promissory note is a negotiable instrument that sets forth the parties, the principal amount of the loan, payment terms (including interest), and the maturity date; and the security agreement grants an interest in the borrower's property (tangible and/or intangible) to a lender as collateral for the loan.

2. Important Terms

Whether a franchisor's loan documents are part of a simple unsecured financing program or a more complex financing structure, there are a few terms of particular relevance to a franchise relationship beyond standard financing language (such as payment terms, maturity date and interest rate), including a cross-default provision, disbursement conditions tied to construction, acceleration of the loan amount in the event of a breach of the franchise agreement, and securing the franchisor's interest in specific equipment and all of the property of the franchisee, including the franchisee's interest in the franchise agreement, accounts receivable and intangibles.

The underlying loan agreement should contain a cross-default provision so that an event of default under the franchise agreement (or any related agreements) is considered to be an event of default under the loan agreement, with the franchisor having the option to accelerate repayment on the loan. Also, rather than dispersing the loan amount in a lump sum, some franchisors choose to disperse the loan in multiple payments upon the franchisee completing certain requirements (e.g., construction) or satisfying other prescribed conditions. A franchisor's loan agreement also may provide for a security interest in the franchisor's proprietary equipment and the franchise agreement in order to help the franchisor maintain control over its proprietary equipment and the franchise agreement should the franchisee become insolvent.

3. Practical Considerations

In recent years, many franchisees have had to refinance mortgages or construction loans that may be senior to an interest recorded by the franchisor. Refinancing these senior loans often involves negotiating intercreditor or subordination agreements with third party financial institutions or other investors, and depending on the number of loans, it can lead to significant costs for a franchisor. In addition, some senior lenders require their own security interest in the franchisee's business, so negotiations can be difficult and time-consuming for a franchisor with limited resources. Therefore, franchisors should consider including language in their franchise agreement granting the franchisor sole discretion as to whether a franchisee can modify an existing loan in which the franchisor has a security interest, and in the event the franchisor permits a modification, requiring the franchisee to be responsible for all costs and expenses the franchisor incurs in connection with the modification.

Franchisees may offer to use their residences as collateral for a loan, but franchisors should first weigh the risks of taking a security interest in residential property (as opposed to an interest in specific equipment) where foreclosing on such property often is difficult (or nearly impossible) and requires additional resources. If the franchisee owns the real property on which the franchised business is located, franchisors also may be able to take a security interest in

that property. Franchisors, however, should seek experienced real estate counsel in the state where the property is located because many states require the filing of state-specific forms in order to perfect the security interest in the property. In the current financial environment, where business loans and other financing can be hard to come by for franchisees, franchisors must determine which risks are acceptable and which to avoid in order to protect their brands while still growing the franchise network.

Franchisors often have franchisees sign a promissory note when a franchisee owes royalties or other amounts payable to the franchisor under the franchise agreement; however courts have reviewed obligations under the note independent of the franchise agreement. For example, in *Pizzeria Uno Corp. v. Pizza by Pubs, Inc.*,[31] Joseph M. Eways ("Eways"), the president of the franchisee entity, individually and as president of the franchisee, executed a promissory note in favor of the franchisor, Pizzeria Uno. Under the terms of the promissory note, Eways agreed to make monthly payments on the past due amounts. After failing to make several payments to Pizzeria Uno, including the amounts past due under the note, Pizzeria Uno sued the franchisee and Eways for breach of the promissory note. The defendants argued that a determination of the parties' rights under the promissory note is predicated on the parties' obligations and rights under the franchise agreements; however, the court disagreed. The court held that the promise to repay under the promissory note is independent of prior dealings between Pizzeria Uno and the defendants under the franchise agreements. The court concluded the defendants breached the express terms of the promissory note, without the need to determine the parties' rights under the franchise agreements.

G. Payment Agreement/ACH Authorization Form

1. Purpose

With today's technology, franchisors can easily initiate debits directly from the franchisee's bank account for the royalty or other amounts due to the franchisor. This process, however, requires the appropriate authorization from the franchisee. While the franchise agreement should clearly state that the franchisee will provide the franchisor with access to its account for payment of amounts due to the franchisor under the franchise agreement, banks will typically require a separate form of authorization to allow the franchisor to access the account. The franchise agreement should require the franchisee to sign a payment agreement or ACH authorization form at the beginning of the franchise relationship and as needed throughout the franchise term, so that the franchisor continuously has access to the franchisee's account for payment purposes.

2. Important Terms

The ACH authorization form must include the name of the depositor on the account. While this is typically the same name as the franchisee, this needs to be clearly stated on the authorization form. The name and specific location of the bank in which the account is held must be provided. The account number from which the franchisor will debit payments must be listed, as must the routing number of the bank. It is also helpful to include a name and contact information of someone at the bank in the event the franchisor's accounting department needs to contact the bank directly.

[31] No. 09-12015-DJC, 2011 WL 4020845 (D. Mass. Sept. 9, 2011).

The form should include an authorization allowing the franchisor to initiate debit entries from the account, and potentially to make credit entries if corrections are necessary. The authorization should direct and authorize the bank to make such debit or credit entries at the direction of the franchisor. The term of the authorization should run for as long as the franchisee holds the account, with notice required to the franchisor from the franchisee if the account is terminated.

3. **Practical Considerations**

As most franchise agreement terms are at least ten years long, it is likely that the franchisee may change bank accounts during the course of the franchise term. The franchise agreement should provide that if the franchisee changes accounts after providing the franchisor with an ACH authorization for its initial account, the franchisee will provide the franchisor with sufficient advance notice of the closure of the initial account and then provide the franchisor with an ACH authorization for the new account.

The franchise agreement also should provide that it is an event of default if the franchisee fails to maintain sufficient funds in its account to enable the franchisor to debit royalties and other amounts owed to the franchisor under the franchise agreement. Therefore, the franchisor's accounting department also should carefully watch all debits made to ensure there are sufficient funds in each franchisee's account. Any notice received from the bank informing the franchisor that there are insufficient funds in the franchisee's account should be treated as a breach of the franchise agreement and the franchisor should follow its defined collection and default practices to receive the payment due from the franchisee.

H. **Real Estate Agreements: Lease, Sublease, or Collateral Assignment of Lease**

1. **Purpose**

The success of a franchise system depends on the success of its franchised businesses. Each franchised business's success depends, in part, on the real estate on which the franchised business is located. Franchisors typically desire to have some control over the real estate on which their franchisees operate. There are multiple reasons why this is preferred. First, franchisors want to make sure their franchisees are successful and therefore do not develop at locations that are not conducive to success. Second, franchisors may desire to maintain control over a good location upon the expiration or termination of the franchise.[32]

A franchisor can obtain control over the franchisee's real estate in several ways. In most franchise systems, the franchisee leases the real estate directly from a third party landlord. In these instances, the franchisor may require that the franchisee obtain the landlord's consent to a lease rider that provides certain protections for the franchisor. In conjunction with this lease rider, or as a separate method of obtaining control, the franchisor may require that the franchisee enter into a collateral assignment of the lease with the franchisor, effective only upon the default of the franchisee under the lease or the franchise agreement.[33] Alternatively, in

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[32] Mark D. Shapiro and Susan E. Wells, *Lease Issues Particular to Franchise Systems*, ABA 30th Annual Forum on Franchising (2007); *See also* Kathryn M. Kotel, Mark D. Shapiro, & Joseph J. Fittante, *Field of Dreams: Controlling the Real Estate*, ABA 26th Annual Forum on Franchising (2003).

[33] Shapiro, *supra* note 22.

some franchise systems, the franchisor enters into a lease with the third party landlord for the real estate on which the franchised business operates, and then subleases the real estate to the franchisee.[34] In determining the most effective ways to control the real estate in a franchise network, franchisors must assess a number of different factors, including the manner in which the franchise system is structured, the franchisor's ability to access capital, and the franchisor's risk tolerance.

2. Important Terms

a. Lease Riders

As the lease rider becomes part of the actual lease agreement between the franchisee and the landlord, it is imperative that the rider specifically provide that the franchisor is a third party beneficiary of the lease, allowing the franchisor to exercise its rights under the lease rider. The lease rider should state that the franchisee is permitted to operate a franchised business at the premises under the franchisor's marks, as those marks may change over the course of the lease term. The rider also may provide that the franchisor has the right to enter onto the premises upon the termination or expiration of the franchise agreement to remove all of its proprietary marks and trade dress. The lease rider also should limit the franchisee's use of the premises to the franchised business operated by the franchisee under the franchise agreement, preventing the franchisee from terminating the franchise agreement and remaining at the same location to operate another business, many times in violation of a post-term non-competition covenant contained in the franchise agreement.

The franchisor also will want to limit the franchisee's ability to assign the lease to a third party without not only the landlord's consent, but also with the franchisor's prior written consent. The rider may provide for exceptions to its assignment restrictions which allow the franchisee to assign the lease to the franchisor or another approved franchisee without the landlord's consent. The rider should require the landlord to provide the franchisor with copies of any notices of default the landlord sends to the franchisee. The rider also should provide that the lease cannot be amended without the franchisor's consent. Finally, the rider should state that if any terms of the rider are inconsistent with the terms of the lease, the terms of the rider control.

b. Collateral Assignment of Lease

A collateral assignment of the lease provides the franchisor with the option to assume the lease for the real estate on which the franchised business operates from the franchisee upon the franchisee's default under the franchise agreement or lease. This allows the franchisor the discretion to retain the franchised business's location in the network if it remains a desirable location that the franchisor believes can be operated successfully either by the franchisor or another franchisee. If the franchisor exercises a collateral assignment, it is likely that it will have to cure all of the franchisee's defaults under the lease. The collateral assignment should provide that any payments made by the franchisor to the landlord remain the liability of the franchisee and the franchisor has the right to seek recovery from the franchisee (and all guarantors) for these costs.

The collateral assignment should specify the process by which the franchisor elects to exercise its right to assume the lease. The assignment also should include an indemnification

[34] *Id.*

of the franchisor by the franchisee from liabilities arising during the franchisee's lease term, as well as any liabilities arising as a result of the franchisor's exercise of its rights to assume the lease, including costs incurred by the franchisor to repair the premises and return it to good working order if required.

The collateral assignment also should provide that the lease may not be amended by the franchisee or the landlord without the franchisor's prior written consent. The assignment should specify the governing law and choice of forum in the event of any dispute arising under the collateral assignment. As mentioned above, the recommendation is to use the same choice of law and forum as provided in the franchise agreement.

Finally, as the collateral assignment is an agreement between the franchisee and the franchisor, it is imperative that the parties obtain the landlord's written consent to the collateral assignment at the time the assignment is signed.[35] Failure to do so can create a situation where the landlord is not obligated to honor the franchisor's assumption of the lease under the collateral assignment and may use a default situation to extract more rent or other concessions from the franchisor.[36] Simply adding a signature section for the landlord indicating its consent to the terms of the collateral assignment may be sufficient.

c. Sublease

If the franchisor has sufficient capital and a higher risk tolerance, it can enter into a lease directly with a landlord for the premises of the franchised business and then sublease the premises to the franchisee. While the franchisor will ultimately be liable to the landlord for all obligations under the lease, subleasing the franchised business's premises to a franchisee can provide a franchisor with a greater amount of control over the real estate. The sublease should include a cross default to the franchise agreement. This will allow the franchisor to gain possession of the premises through a possessory action in the event of a default under either the sublease or the franchise agreement. The terms of the sublease must be consistent with the terms of the master lease between the landlord and the franchisor, including but not limited to, the initial term and any renewal terms, the use of the premises, pass through charges like common area maintenance and taxes, and the tenant's operating obligations. The sublease also must contain a strong indemnity by the franchisee in favor of the franchisor.

A sublease drafted for a franchisee will typically include provisions that specifically correlate to the terms of the franchise agreement. Examples of these terms include: (i) a narrow use clause limited to the operation of the franchised business; (ii) no right for the franchisee to assign or sublet the premises without the franchisor's prior consent; (iii) no right for the franchisee to make alterations to the premises without the franchisor's prior consent; and (iv) the right for the franchisor to have free access to the premises.[37]

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[35] *See Danbury Mall Associates Ltd. Partnership v. Mazel Enterprises, LLC*, No. CV030347873S, 2004 Conn. Super. LEXIS 1919 (Conn. Super. July 14, 2004), which found the collateral assignment between the franchisor and franchisee unenforceable against the landlord since the landlord did not consent to it.

[36] Shapiro, *supra* note 22.

[37] *Id.* at p. 14.

3. Practical Considerations

Having control of a franchisee's real estate by subleasing the premises to the franchisee typically provides the franchisor with greater protection than available under the terms of the franchise agreement should the franchisee file for bankruptcy. If the franchisor acts as both the landlord of the franchised business's premises and the franchisor of the system, it has the ability to exercise control over the timing and outcome of the franchisee's bankruptcy process.[38] In *In re: FPSDA I, LLC, et. al*[39]*,* the court found that the franchise agreement and the lease between the franchisee and an entity related to the franchisor constituted an integrated transaction and treated them as a single agreement. This required the franchisees to either assume or reject both the franchise agreement and the lease for each franchised business location, instead of allowing them to assume the lease without also assuming the franchise agreement.

Gaining control of the franchised business location through a collateral assignment may provide the franchisor with protection in a franchisee's bankruptcy. However, the bankruptcy courts are split on whether the rejection of a lease as an executory contract is a "termination" of the lease triggering the franchisor's right to assume the lease.[40] The likelihood of the franchisor effectively exercising its rights under a collateral assignment in a franchisee's bankruptcy is greatly diminished if the landlord has not expressly agreed to the terms of the collateral assignment.

Franchisors who intend to grant franchises in states where a post-term non-competition covenant is generally unenforceable, such as in California, should strongly consider using one the aforementioned methods to control the premises of the franchisee's franchised business upon the expiration or termination of the franchise agreement. By gaining control of the premises at the end of the franchise relationship, franchisors can have some comfort in knowing that the franchisee will not be able to compete with the franchise system from the same premises at which it was operating during the term of the franchise relationship.

Franchisors also must be careful to ensure the method chosen to control the real estate does not imply that the site selected – whether it is selected by the franchisee and just approved by the franchisor, or selected directly by the franchisor – will be a successful location for the franchised business. Franchise agreements typically include disclaimers by the franchisor that any approval of the site does not guarantee that the franchisee will be successful at such site. However, adding a similar disclaimer to either the collateral assignment document or a sublease is also advisable.

I. Broker Agreement

1. Purpose

When looking to grow the number of franchised units, franchisors must decide whether to use the skills of their own employees as an in-house franchise sales staff or the skills of independent contractor franchise brokers as an external franchise sales staff. In making that decision, franchisors must determine whether they have the resources available to meet their

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[38] *Id* at p. 15.

[39] 450 B.R. 392 (Bankr. E.D.N.Y. 2011).

[40] *Id.*

expansion targets. Many franchise systems simply do not have the in-house resources available. In those instances, franchisors frequently enlist the assistance of franchise consultant and broker networks to help generate leads for potential franchisees that they may otherwise never have the opportunity to meet. Ideally, franchise brokers, in exchange for a commission, will help the franchisor screen prospective franchisees to confirm the prospect has the skills and budget to succeed in the particular franchise system. The broker agreement outlines the terms of the arrangement between the broker and franchisor.

2. <u>Important Terms</u>

The broker agreement between the franchisor and broker should specify the territory in which the broker may solicit prospective franchisees, and whether the rights of the broker will be exclusive or non-exclusive. Over time, the needs of the franchisor will change, therefore broker agreements often are short term agreements (e.g., 3 year terms) with the right for the franchisor to terminate the agreement prior to its expiration if the franchisor decides to cease offering franchises in the territory. The broker's responsibilities should be clearly defined in the broker agreement, which typically include, among others: (1) soliciting and screening prospective franchisees; (2) franchise sales consulting services; and (3) the obligation to conduct all advertising and promotion of the franchise system in a dignified and lawful manner. On the other hand, the franchisor is responsible for making available to the broker the materials for promoting the sale of the franchise system as well as the guidelines for screening prospective franchisees. Before any prospective franchisee enters into a franchise agreement with the franchisor, the franchisor should reserve the right to give final approval of the prospect. If the prospective franchisee does not meet the franchisor's minimum criteria or the franchisor reasonably believes that the prospect is not a good fit with the franchise system, the franchisor should refuse to approve the prospective franchisee.

The broker agreement also must state the amount of the fee payable to the broker for its services as well as how the fee is calculated (e.g., a flat amount or percentage of the initial franchise fee per franchise agreement signed for a franchised business to be located in the territory). The calculation of the broker fee varies. Some agreements require the franchisor to pay a fee for each franchise agreement signed for a franchised business to be located in the territory, regardless of whether or not the broker participated in the solicitation, screening or qualification of the franchisee, while others require the broker to have participated in the solicitation, screening or qualification of the franchisee in order to be eligible to receive a fee.

It is not uncommon for a franchisor to require all of the broker's personnel having access to the franchisor's confidential information to execute a confidentiality agreement. (See Section II, B above for a discussion of confidentiality agreements). In addition, broker agreements often include in-term and post-term non-competition covenants restricting the broker from selling any franchise or development rights for any competitive franchise systems. Lastly, it is important for the broker agreement to include indemnifications by the broker and franchisor. The broker should indemnify the franchisor for any misrepresentations or omissions to any prospective franchisees or for any other violations of applicable franchise laws, while the franchisor may indemnify the broker for any claims arising out of the franchisor's actions or a breach by the franchisor of its franchise agreement.

3. <u>Practical Considerations</u>

Before using any franchise broker, the franchisor should carefully review the credentials of the broker, including statements from the franchise broker's clients and the litigation history of

the broker and its clients. The broker agreement should state clearly that the broker does not have the right to grant or sell a franchise or commit the franchisor to grant or sell a franchise to any prospect. In addition, the broker agreement should not include a license to use the franchisor's proprietary marks, except in connection with its disseminating materials furnished by the franchisor bearing the marks. In order to help ensure that a broker identifies quality leads, the franchisor should establish a franchise sales process with minimum criteria for prospective franchisees, assist the broker with setting up effective ways to profile the prospective franchisees, and train the broker as to the franchisor's expectations for its franchisees.

Franchisors also should keep in mind that New York and Washington prohibit a franchise broker from offering or selling franchises in the respective state unless the broker registers with the state. If the broker's territory includes either of those states, the franchisor should confirm that the broker has satisfied its registration obligation in the respective state.

While some franchisors may work closely with an individual broker and believe the broker agreement is a "personal services" agreement, brokers often are employed by consultant or broker networks, and the relationship between the broker and the franchisor may not always be considered a personal services relationship. This issue was before the court in *Fransmart, LLC v. Freshii Development, LLC*.[41] In *Fransmart*, an affiliate of the broker, Fransmart, LLC ("Fransmart"), assigned a consulting agreement (the "Agreement") with the franchisor, Freshii Development, LLC ("Freshii"), to Fransmart. The Agreement provided that the assignor was the "sole and exclusive consultant to [Freshii] in the marketing and sales of individual franchises."[42] However, Fransmart's CEO, Dan Rowe, served as the CEO of both Fransmart and its assignor. After learning of the assignment, Freshii refused to pay Fransmart for its marketing and sales services.

Fransmart subsequently sued Freshii for breach of contract. In its defense, Freshii raised several affirmative defenses, chief among them, that Fransmart lacked standing to sue because the Agreement was a non-assignable personal services contract and therefore the assignment was invalid.[43] The court found the terms in the Agreement "make clear that the parties intended to permit this assignment."[44] In addition to analyzing the "successors and assigns" clause, the court found that because the Agreement was "between two corporate entities, lasts for ten years, and contains a clause that provides that [the predecessor's] obligations can be performed by anyone in the company," it was not a personal services contract. [45] Further, the court stated that the Agreement did not identify any person as being material to performance, despite Freshii's claim that Fransmart no longer employed "key employees" of the predecessor entity.[46] Accordingly, the court granted Fransmart's motion for summary judgment on Freshii's claim that Fransmart lacked standing to sue for breach of

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[41] 768 F.Supp.2d 851 (E.D.V.a. 2011).

[42] *Id.* at 856.

[43] *Id.* at 858.

[44] *Id.* at 862.

[45] *Id.*

[46] *Id.* at 863, 864.

contract, and ultimately denied all of Freshii's affirmative defenses to Fransmart's breach of contract claim.[47]

J. ADA Certification

1. Purpose

Title III of the Americans with Disabilities Act[48] (the "ADA") provides that public accommodations, commercial facilities, and certain private entities may not discriminate against any individual with a disability with respect to providing services or facilities. This applies to anyone who owns, leases, leases to, or operates a facility covered by Title III. Within a franchise system, liability for compliance with the ADA will certainly apply to the franchisee as the operator of the franchised facility, but also may implicate the franchisor in a number of ways.[49] While most systems allow the franchisee to contract directly with the architect and contractor for the build-out of the facility, the franchisor will typically require that the franchisee obtain the franchisor's approval of the site for the franchised location, and then require the franchisee to use the franchisor's prototype plans and specifications for the development of the facility. The Department of Justice and disabled individuals have argued that this control subjects the franchisor to liability under the ADA.[50]

Franchisors can shift liability for ADA compliance by the terms of the franchise agreement and any lease or sublease it enters into with its franchisees.[51] However, while this shift in liability is effective in allocating responsibility for ADA compliance as between the franchisor and the franchisee, it does not change any obligations that either the franchisor or the franchisee may have under the ADA or the ultimate liability to the government or third parties for failure to comply.[52]

While the franchise agreement typically requires the franchisee to comply with all laws, and perhaps even calls out specifically the ADA, many franchisors also require the franchisee of a new or remodeled facility to provide the franchisor with a certification of compliance with the ADA before allowing the franchisee to open at the new or remodeled location. This certificate can help reduce the risk to the franchisor of any potential ADA liability arising as a result of the construction of the new or remodeled facility. And since the franchisee is typically not qualified alone to make the certifications required, it also will reduce its potential liability under the ADA by requiring a similar certification from the architect and contractor that the franchisee can then rely upon in making its certification to the franchisor.

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[47] *Id.* at 864, 871.

[48] 42 U.S.C. §12182.

[49] *See* Kathryn M. Kotel and C. Geoffrey Weirich, *The New Era of ADA Compliance: What Does It Mean For Your Franchise System?*, ABA 34th Annual Forum on Franchising (2011).

[50] *See*, *United States v. Days Inn of Am., Inc.*, 151 F.3d 822 (8th Cir. 1998); *United States v. Days Inn of Am., Inc.,* 22 F.Supp.2d 612 (E.D.Ky. 1998); *Neff v. Dairy Queen Corp.,* 58 F.3d 1063 (5th Cir. 1995).

[51] 28 C.F.R. §36.201(b) (2010).

[52] ADA Title III DOJ Technical Assistance Manual §III-1.20000.

2. Important Terms

The franchisor must first determine if it will require the ADA certificate directly from the franchisee's architect, engineer, ADA consultant, or other licensed professional or will ask the franchisee itself to sign the certification. The certificate generally states that the new or remodeled facility conforms to and complies with all of the design standards and requirements of the ADA and the ADA Architectural Guidelines[53] (the "ADAAG"). The certificate also may declare that the person signing the certificate used professionally reasonable efforts to comply with the ADA and ADAAG, as well as with all applicable local and state laws and regulations.

3. Practical Considerations

As franchisees do not typically have the knowledge to make an ADA certification, it is prudent to require the franchisee's architect or other licensed professional to sign the ADA certificate and require the franchisee to deliver the signed certificate to the franchisor prior to the opening of the new or remodeled facility. Franchisees must be certain to inform their architect or contractor of the expectation that this individual or firm will be asked to make the certification to the franchisor or the franchisee. Franchisees need to be aware of whether or not the architect or contractor will agree to provide the certificate prior to the commencement of any construction and, if they will provide the certificate, if there will be any additional costs for it.

K. Equipment Lease

1. Purpose

Many franchisors require franchisees to obtain proprietary equipment under the franchise agreement to provide products or services to customers. Rather than selling this equipment to franchisees, many franchisors elect to lease or rent the equipment to franchisees in order to maintain enhanced control over the equipment. Such proprietary equipment may include anything from kitchen equipment used to prepare products sold to customers to lawn mowers or carpet cleaning equipment used to provide services to customers. Franchisors sometimes manufacture their proprietary equipment (and the franchisees would not otherwise be able to obtain the equipment), and other times they purchase the equipment from third parties and lease it to franchisees. Nonetheless, equipment leases can provide franchisors with more control over their proprietary equipment, by including maintenance and use standards, insurance requirements, and the obligation to return the equipment upon termination or expiration of the franchise, thereby protecting their proprietary interest.

2. Important Terms

Equipment leases typically include provisions to address rent, cross-defaults with respect to the franchise agreement or any other agreements between the parties, title to the proprietary equipment (which the franchisor retains), maintenance and repair obligations, and, for some equipment (such as automobiles or lawn equipment), minimum insurance requirements. Rent due under an equipment lease often is required up front as a lump sum payment included in the initial franchise fee, or it may be paid in installments. The equipment lease should contain a cross-default provision so that an event of default under the franchise agreement is considered to be an event of default under the lease, with the franchisor having

[53] 2010 ADA Standards for Accessible Design, (http://www.ada.gov/regs2010/2010ADAStandards/2010ADAStandards_prt.pdf).

the option to terminate the equipment lease and require the franchisee to return the proprietary equipment to the franchisor. The equipment lease should provide that the franchisor retains title to the proprietary equipment, with the franchisee's rights limited to use of the equipment during the term of the lease. However, the franchisee should be responsible for regular maintenance and repairs. For certain proprietary equipment (such as lawn equipment or automobiles) or other insurable pieces of equipment, it is worthwhile for franchisors to include insurance requirements (naming the franchisor and its affiliates as additional insureds) specific to the equipment that go beyond the more general insurance requirements under the franchise agreement. It also may be prudent for franchisors to file a UCC-1 on the equipment, securing the franchisor's interest in its proprietary equipment, and to require franchisees and the franchisees' owners (if the franchisee is an entity) to sign personal guarantees in connection with the rent due under the equipment lease.

3. Practical Considerations

Equipment leases are a good option for franchise systems that involve specialized or patented equipment, where the franchisor has made an investment in developing the proprietary equipment and wants to retain ownership and control over the equipment that its franchisees are required to obtain to provide products or services to customers. The downside of leasing the equipment is that it requires another on-going payment from the franchisee (and the risks of non-payment associated therewith), the need for the franchisor to secure possession of the equipment upon the expiration or termination of the lease, and more documentation than if the franchisor simply sells the equipment to the franchisee.

L. Software Licenses

1. Purpose

In virtually all franchise systems today, the franchise agreement requires franchisees to use specific software in the operation of the franchised business. The franchisor may require that franchisees use specific point-of-sale software to ensure franchisees accurately record all sales in their business and produce consistent reports across the franchise system. Other franchisors may have more extensive requirements, such as software that can track sales and inventory and either automatically send all such information to the franchisor on a routine basis or allow the franchisor to obtain this information through its own access to the franchisees' computer systems. Since most systems have specific software requirements that are imposed on franchisees, the FTC Franchise Rule requires disclosure about the software and maintenance requirements and how the franchisee is expected to obtain such software.[54]

Some franchisors merely identify the specific software required to be used by their franchisees and then place an obligation on the franchisees to enter into their own agreements with approved software providers. Other franchisors either develop their own proprietary software or enter into a master license agreement with a third party software provider. In either of these instances, the franchisor often omits the grant of a software license from its franchise agreement and instead requires its franchisees to enter into a separate software license with the franchisor for use of this software.

[54] 16 C.F.R. § 436.5(k).

2. Important Terms

As any proprietary software franchisors require franchisees to use to operate their franchise businesses is typically an important component of the overall franchise system, franchisors should carefully craft their software licenses to provide sufficient control over the use of the system's proprietary software. A franchisor's software license should grant a license to the franchisee to use the franchisor's software. The software included in the license should be specifically described in the license. This license should be nontransferable and nonexclusive. As the franchisor will want to protect the use of any proprietary software and limit its use to within the franchise system, the grant of the license should be limited to the use at the specific franchised business location(s) if the business is operated at a site specific location. The license also should expressly state that the software is to be used solely in conjunction with the operation of the franchised business.

The term of the software license should run concurrently with the term of the franchise agreement. Franchisors should consider including a cross default to the franchise agreement to ensure that a default and termination of the franchise agreement results in a termination of the software license.

As the license is for software typically considered proprietary to the franchise system, the license should include a confidentiality provision. Additionally, the license may include restrictions that prohibit the franchisee from undertaking any action to reverse engineer the software, using the software to process any data not associated with the franchised business, or modifying or changing the software licensed.

The agreement should clearly indicate who owns all rights to the software – typically the franchisor. However, if the franchisor owns these rights, the franchisor also should expect to indemnify the franchisee from any infringement claim brought by a third party against the franchisee related to the franchisee's authorized use of the software. The franchisor must carefully consider the warranties it will make in the license. The franchisor may want to only warrant that it has clear title to the software and disclaim any other warranties, including any warranties that the software is fit for a particular purpose or for its intended use.

The license should describe the franchisor's obligations to install the software and train the franchisee on its use, if any. The license also should contemplate future updates or changes to the software because with the ever-evolving nature of technology, franchisors need to have the contractual right to update the software used within their systems over the course of a franchise term. Franchisors must decide whether they expect their franchisees to pay for updates and, if so, if the franchisor will impose upon itself any limitations on the frequency of required updates over the life of the franchise or on the cost to the franchisees for each update.

3. Practical Considerations

Older franchise agreements often do not provide for software requirements nor do they include an obligation for the franchisee to enter into a separate software license agreement with either the franchisor or an approved software provider. In these instances, the franchisor is faced with challenges when it now wishes to require the entire franchise network to use specific software. The franchisor may be able to incorporate the software requirements into its current operations manual as a system standard; however, the franchisor must take into account the franchisees' costs associated with the new required software before doing so. If licenses are needed for each franchisee to use the software, the franchisor must either convince each of

these existing franchisees to enter into the separate software license or wait until each of the existing franchisees' franchise agreements are renewed and have the franchisees sign the franchisor's then-current form of franchise agreement which should include language giving the franchisor the needed flexibility to require franchisees to use specific software in the operation of the franchised business.

Franchisors need to carefully consider the type of software needed to most effectively operate their systems. Mature systems may already have software in place that address their current needs. New franchisors need to spend the time to analyze the best way to operate their systems and how to access the software needed to meet the system's particular requirements. Smaller franchisors may not have the internal expertise or the financial wherewithal to develop their own proprietary software and may instead elect to obtain software from third parties. Franchisors should consider whether they want to control this and therefore should enter into a master agreement with the software provider, or whether the software is one that the franchisor reasonably believes can be directly licensed by the franchisee from the provider.

M. <u>Gift Card Participation Agreement</u>

1. <u>Purpose</u>

Gift cards are widely used today by most retail businesses. There are a significant number of legal issues to consider when developing a gift card program for a franchise system that are outside the scope of this paper.[55] However, as a good business practice and in order to stay competitive, many franchise systems have established gift card programs. The use of gift cards in a franchise system is an effective tool to generate revenue and brand awareness.[56] As these programs did not exist in many systems at the time franchisors entered into franchise agreements with its current franchisees, franchise agreements often do not address gift card issues. As gift card programs are developed, new franchise agreements may contain language requiring the franchisee to participate in the program, as well as addressing some or all of the related terms applicable to the gift card program (e.g., required software, definition of gross sales, etc.). But, arguably, a gift card program is most effective if the entire system participates, requiring franchisors to address these requirements with older franchisees through operations manual changes and separate agreements.

In implementing a gift card program, many franchisors enter into master agreements with third party suppliers or administrators that will provide hardware, software, and operational support for the gift card program. These agreements may provide that the franchisor – or both the franchisor and third party supplier – will enter into separate agreements with each franchisee as they enter the gift card program so that the terms of the master agreement with the franchisor apply to each franchised business location as well.

2. <u>Important Terms</u>

Regardless of which form of agreement the franchisor elects to use to implement and operate a gift card program, the agreement must address how the funds will be held from the

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[55] *See* David M. Byers, Tywanda H. Lord & Bret Lowell, *Gift Cards and Loyalty Programs in Franchise Systems*, ABA 33rd Annual Forum on Franchising (2010); *See also* Diane Green-Kelly, *Gift Certificate and Gift Card Programs: The State Law Quagmire*, 23 Franchise L.J., No. 4 (Spring 2004).

[56] Byers, *supra* note 27 at 2.

sale of gift cards and when the franchisee owes royalties to the franchisor. Customers frequently purchase a gift card from one franchised location and later redeem that card at another franchised business location. Most gift card programs operate by contributing the funds generated from the sale of gift cards to a gift card fund which is held either by the franchisor, a separate entity created by the franchisor, or the third party supplier or administrator. As cards are redeemed, the redeeming franchised business receives payment from the fund for the value of the goods or services purchased with the gift card. Additionally, most franchise systems consider the redemption of the gift card as the trigger for assessing royalties because the franchised business that sold the gift card must contribute the funds received from the sale to the gift card fund.

As there are considerable state specific escheat questions raised by a gift card program[57], the applicable state law and breakage issues must be addressed. Will the breakage be returned to franchisees, and, if so, either individually or equally across all franchisees? Or, can it be retained by the marketing fund for future marketing of the gift card program for the franchise system?

The agreements also should address what happens in the event that the franchisee does not fund its obligations under the gift card program or ultimately ceases to operate the franchised business or files for bankruptcy. If the franchisee is in a deficit position under its financial obligations to the gift card program, can the franchisor or third party supplier or administrator retain future credits due the franchisee until such time as the deficit is resolved, or prevent the franchisee from activating additional gift cards? If not already addressed in the franchise agreement, is the failure to comply with the gift card participation agreement a default under the franchise agreement?

If the franchisor obtains personal guarantees from the principals of the franchisee entity, the franchisor should require these guarantors to sign the gift card participation agreement as guarantors as well.

3. Practical Considerations

The considerations for the development of a gift card program are beyond the scope of this paper. However, franchisors need to seriously consider the details involved in developing a gift card program and spend the appropriate time and money to properly develop a program that works for its system and minimizes risks to both the franchisor and franchisee.

One of the most prevalent considerations today is how to implement a gift card program that includes an entire franchise system without any explicit right to do so under the terms of the existing franchise agreements. Franchisors should explore options such as incorporating the terms of the program into their operations manual and marketing programs.

N. Loyalty Program Participation Agreement

1. Purpose

Customer loyalty programs, often known as rewards or frequency programs, can be described as ongoing promotional programs that allocate points or other metrics to recognize a

[57] *Id.*

customer's frequency of use or purchases of a system's products or services.[58] These types of programs started within the airline industry but are now prevalent in many retail businesses, including virtually all parts of the hospitality industry (e.g., hotels, restaurants, and rental car businesses). Franchisors that develop a loyalty program for their system typically use a separate agreement to extend the rights and obligations of the program to its franchisees. While the requirement to belong to the loyalty program may be incorporated into more recent franchise agreements, the specific terms of the program often are left out of the franchise agreement and instead incorporated into a loyalty program participation agreement.

2. Important Terms

The loyalty program participation agreement must detail both the franchisor's and franchisee's respective obligations under the program. Does the franchisor charge a separate participation fee to the franchisee to cover the franchisor's costs to operate the program? If so, the fee needs to be articulated in the agreement.[59]

By its very nature, the creation of a loyalty program results in the collection of personal data about the franchise system's customers. Therefore, it is imperative that the participation agreement requires the franchisee to not only keep the terms of the system's program confidential, but to also keep all customer data confidential. In addition to creating a violation of any local or federal privacy laws, an improper disclosure or use of customers' private information by a franchisee or its employees can create a systemwide brand damaging event. The agreement also should make it clear that the franchisor, not the franchisee, owns all of the data collected about the system's customers.

A loyalty program participation agreement also may provide that the franchisor has no obligation to identify fraudulently obtained program cards or to report any fraud, theft or dishonesty committed by any person other than an employee of the franchisor. The franchisee should be financially responsible for any fraudulent or erroneous redemption of rewards made by the franchisee's employees. In addition, the franchisee should indemnify the franchisor for any liabilities incurred by the franchisor as a result of the franchisee's participation in the loyalty program.

The loyalty program participation agreement should be coterminous with the term of the franchise agreement. Franchisors should consider making a default of the participation program a default under the franchise agreement. If the franchisor obtains personal guarantees from the principals of the franchisee entity, the guarantors also should sign the loyalty program participation agreement as guarantors.

3. Practical Considerations

Many franchise systems operate multiple brands. A franchisor that creates a loyalty program should consider developing its loyalty program to apply across its multiple brands. This is commonly seen in hotel systems. If the franchisor gives itself this flexibility, the

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[58] *Id.* at 1.

[59] *But see Bird Hotel Corp. v. Super 8 Motels, Inc.*, No. Civ 06-4073, 2010 WL 572741 (D.S.D. Feb. 16, 2010) in which the court held that while the franchisor had the right to change its system to add the loyalty program, the franchisor did not have the right to unilaterally revise its franchise agreement to require the payment of a mandatory fee for the loyalty program to existing franchisees.

participation agreement should articulate this point and the requirement for a franchisee in one brand to accept rewards earned by customers utilizing other brands within the same family of franchise system brands. If the franchisor operates multiple brands but has not yet decided about redemption across its family of brands, the franchisor can reserve this right in the agreement.

The franchisor also needs to determine how redemption of points or rewards will be handled within the franchise system. How is the franchisee that accepts a customer's use of its reward points compensated for the free product or services that it must provide to such customer? In some systems, this can have a negative impact on some franchisees that are located in more sought after locations, such as hotels at vacation destinations for which customers might more frequently use earned rewards to obtain free nights. While there are many ways to address awarding and redeeming points in a loyalty program, there are four that are most typically used: (1) assessment of a general fee based on the revenue generated from all transactions in all locations to fund a pool used to pay for redemptions; (2) assessment of a fee based on the number of points awarded, charged to the franchisee who awarded the points when the sale was originally made; (3) a fee assessed on the originating franchisee when points awarded by the franchisee are redeemed; and (4) a requirement that each franchisee redeem points for no additional compensation.[60] The format the franchisor elects to use must be articulated in the participation agreement. Alternatively, this can be fully explained in the franchisor's operations manual or program materials, and the participation agreement can reference the manuals or program, incorporating its terms by reference.

Lastly, franchisors should keep in mind that any fees charged under the participation agreement must be disclosed in Item 6 of the franchisor's FDD.[61] Additionally, if the franchisor reserves the right to change the fee from time to time over the term of the franchise agreement, this must be built into the participation agreement and properly disclosed.

O. Supplier Agreement

1. Purpose

There are few types of supplier agreements common to the franchise industry.[62] First, there is the supplier agreement in the context of a franchisor or its affiliate as the supplier of proprietary or branded products to franchisees. Second, there is the supplier agreement in the context of a franchisor establishing a formal purchasing program or system with external vendors. Third, there is the supplier agreement in the context of a franchisor having pre-negotiated a form of "supplier agreement" for franchisees to sign with third-party vendors (usually where the franchisor has established a formal purchasing program with a volume discount). Each of these types of supplier agreements contain terms such as product descriptions and specifications; minimum required purchases (or supply volumes); exclusivity provisions; pricing or methods of determining prices; shipping and delivery provisions (such as

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[60] Byers, *supra* note 27 at 36.

[61] 16 C.F.R. § 436.5(f).

[62] *See* Chesley K. (Bud) Culp and Rochelle B. Spandorf, *Sourcing Products and Services for the System: Efficiencies and Traps in Supply Chain Management and Outsourcing*, ABA 32nd Annual Forum on Franchising (2009): *See also,* Gina Romo, James Straus, & Suzanne Loonam, *Building an Effective Franchise System Supply Chain*, ABA 35th Annual Forum on Franchising (2012).

which party is responsible for risk of loss during delivery); and other similar terms and conditions typically found in supply and purchase agreements.

2. Important Terms

a. Franchisor/Affiliate Approved Supplier Agreement

A supplier agreement between the franchisor or one of its affiliates and the system's franchisees is the most straightforward of the supplier agreements. In addition to the terms and conditions typically found in a supply and purchase agreement, similar to most other ancillary agreements to which franchisees are a party, the supplier agreement should include a cross default provision (with the franchise agreement) in the event the franchisee breaches the supplier agreement. Franchisors also must make sure to leave themselves the flexibility to change the designated supplier should the franchisor wish to appoint a third-party supplier in the future. Further, the agreement should automatically terminate upon the termination of the franchise agreement (especially if the supplier agreement is to supply franchisees with proprietary or branded products).

b. Purchasing Program Supplier Agreement

Supplier agreements between franchisors and third-party vendors are generally used in situations where the franchisor is establishing a formal purchasing program with external vendors for the benefit of the system's franchisees. Benefits of such agreements may include reflecting reduced prices for products, services, and/or equipment, having been negotiated by the franchisor and the supplier based on expected sales volume or the number of franchisees in the network.

Some franchisors and suppliers may use these agreements to promote certain products and offer rebates to franchisees for achieving minimum sales volume. Franchisors may be able to negotiate exclusivity depending on whether they have the ability to require their franchisees to purchase products or services through the purchasing program. These supplier agreements also can set forth a franchisor's expectations for quality, safety, and delivery standards, to further protect its brand and product through uniformity, as well as permit the franchisor to inspect the supplier's premises periodically to ensure the supplier's compliance with the franchisor's standards. It is important for these agreements to describe the franchise relationship between the franchisor and its franchisees and include acknowledgements by the parties that the franchisees purchasing the products or services are independently owned and operated, and the franchisee is the sole party liable for any amounts owed to the supplier. Such acknowledgments can help protect franchisors from claims by suppliers as a result of franchisee breaches. In addition, franchisors must be sure to include the right for them to approve the form of supplier agreement between the supplier and their franchisees because disputes between approved suppliers and franchisees can disrupt the system and end up involving the franchisor who "approved" the supplier.

c. Third-Party Vendor Supplier Agreement

Pre-negotiated forms of supplier agreements for franchisees to sign with third-party vendors are generally a product of purchasing programs as discussed in the immediately preceding subsection. As with the supplier agreement between the franchisor and vendor, such supplier agreements should describe the franchise relationship and include acknowledgements by the parties that the franchisee purchasing the products or services is independently owned

and operated, and is the sole party liable for any amounts owed to the supplier. Such acknowledgments can help protect the franchisor from a franchisee who is past due on invoices, or is misusing a supplier's services or equipment. Conversely, a similar acknowledgment should be included whereby the parties acknowledge that the supplier is unaffiliated with the franchisor in the event issues arise regarding late deliveries, product quality concerns, or problems with placing orders. If the franchisor has negotiated rebates or other benefits for the system's franchisees, the relevant terms should be included in the agreement. The agreement should require the supplier to notify the franchisor of any defaults under the supplier agreement, which may be deemed to be a default under the franchise agreement. In addition, the supplier agreement should automatically terminate upon the termination of the franchise agreement.

3. Practical Considerations

Being able to terminate a supplier agreement for product quality issues or if the supplier is facing liquidity issues (and is unable to fulfill orders) can be essential for the survival of a franchise system. Franchisors must be able to separate promptly from the problematic supplier and provide its franchisees with alternative sources for the products or services in order to avoid disruption in the system. Depending on the importance of the particular product or service the supplier is supplying to the network, franchisors should consider approving multiple suppliers for the product or service to ensure that the franchisees' demands for the product or service can be met even if one of the suppliers fails to perform. While franchisors are not in the business of refereeing disputes, supplier disputes can cause disruption to the franchise system. Therefore, franchisors may want to consider how involved to be in disputes or problems between a franchisee and a supplier, and capture in the supplier agreement the extent to which the franchisor will manage or administer the supplier relationship.

Franchisors who seek to negotiate exclusive relationships with suppliers should beware of "tying" claims under federal antitrust statutes. Antitrust laws are generally not an issue if the supply agreement relates to optional products or services. However, if the supplier agreement relates to a required product being supplied to franchisees on an exclusive basis, and the franchisor has an economic interest in the arrangement (such as being an affiliate of the supplier), the franchisor may be at risk of violating federal antitrust laws. This scenario was the basis of *Burda v. Wendy's Intern., Inc.*[63], where the franchisee brought a breach of contract claim against the franchisor, Wendy's, alleging Wendy's changed its policy and required "tied" products after the franchisee was "locked-in" by the franchise agreement. Further, Wendy's imposed a per-case surcharge on purchases of food products the franchisee made from any other suppliers. The court conducted an analysis of the parties' franchise agreement, and agreed with the franchisee. The court determined there was "…no language in the agreement that would put a potential franchisee on notice that [Wendy's] would be able to eliminate all competition by naming an exclusive supplier or that they could impose a surcharge on approved suppliers."[64] Rather, the court found that the terms of the franchise agreement welcome competition among suppliers as long as the suppliers met Wendy's standards.[65] Accordingly, the court held that the plaintiffs had successfully pled an antitrust claim and ultimately denied Wendy's motion to dismiss.

[63] 659 F.Supp.2d 928 (S.D.Ohio. 2009).

[64] *Id.* at 935.

[65] *Id.*

P. Purchasing Co-op Agreement

1. Purpose

Although an in-depth discussion of the issues associated with the formation and operation of a purchasing co-op are beyond the scope of this paper[66], the authors believe it is prudent to include a short discussion about the use of a purchasing co-op and the associated agreements as purchasing co-ops are becoming more common. Purchasing co-ops are typically used in a franchise system to provide economies of scale for the system, decrease costs, share strengths among the franchisor and franchisees, promote innovative processes, and provide its members with a return on investment.[67]

In a member-owned co-op, in which the franchisor and franchisees are members, there will be an operating agreement created upon the formation of the co-op to address how the co-op will be managed and funded. There also will be a relationship agreement between the franchisor and the co-op to set forth how the co-op will work within the franchise system and what rights and obligations each of the franchisor and the co-op will have. Finally, there should be a subscription agreement by which individual franchisees agree to become members of the purchasing co-op. In the event the manner in which the purchasing co-op will operate conflicts with the purchasing provisions of existing franchise agreements, an amendment to the existing franchise agreements also may be needed to clarify any such discrepancies.

2. Important Terms

The corporate and tax structure chosen for the co-op will be included in the operating agreement. The overall management structure and division of responsibilities also will be detailed in this agreement.

In the relationship agreement, the franchisor must be clear that the control it has retained in the franchise agreement over the purchasing of products used within the franchise system continues in the purchasing co-op structure. The franchisor will want to continue to have the same approval of all suppliers, products, and related marketing work as granted under the franchise agreement. The agreement should address how the franchisor will continue to protect the brand and the franchisor's marks, and the role the co-op will have in promoting the marks. This agreement also should address how vendor rebates will be handled (i.e., will the co-op be entitled to retain all vendor rebates or is the franchisor entitled to some or all of the rebates for itself or on behalf of the franchise system). The relationship agreement also may contain dispute resolution terms in the event of any disputes between the franchisor and the co-op. Finally, confidentiality of both parties' information should be addressed.

The subscription agreement provides that the franchisee will purchase all products and use distribution services through the co-op. It also is typical to require the franchisee to remain in good standing with the franchisor in order to remain a member of the co-op. The franchisee's co-op membership typically cannot be transferred to anyone outside of the franchise system.

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[66] *See* Joyce Mazero and Suzie Loonam, *Purchasing Cooperatives: Leveraging a Supply Chain for Competitive Advantage*, Franchise L.J., Vol. 29, No. 3, Winter 2010, 148.

[67] *Id.* at p. 148.

3. Practical Considerations

When developing a purchasing co-op, franchisors and franchisees need to carefully consider the structure of the co-op relative to ownership rights and products covered by the co-op. There also are tax consequences of various co-op structures that need to be considered. Initial and ongoing funding also must be addressed. Antitrust issues also can arise in a purchasing co-op arrangement if it is not structured and operated properly.[68]

Q. Terms of Use Agreement for Shared Network and Online Access

1. Purpose

Most franchise systems provide an intranet site as a communication network for the benefit of the franchise system and franchisees. Intranet sites are usually password protected and access is limited to the system's franchisees. As a condition to receiving access to the site, franchisees must sign the franchisor's terms of use agreement. It is not uncommon for a terms of use agreement to be paired with an online access agreement in which the franchise system's rules and procedures for access to the public internet and/or displaying a website (or customizing a webpage on the franchise system's website) are specified. By signing the terms of use and online access agreement, franchisees agree to abide by the franchisor's rules and procedures for: (1) the intranet; (2) online access; and (3) websites, in return for permission to access the franchise system's intranet, utilize the public internet and create a website (or webpage on the franchise system's website).

2. Important Terms

With respect to the terms of use provisions, the agreement should specify which, if any, of the franchisee's employees may access the franchise system's intranet. Terms of use also generally contain the following important provisions: (1) confidentiality provisions to help protect the franchisor's posting of its confidential and proprietary information (e.g., manuals and training materials); (2) privacy and data collection provisions acknowledging the franchisor's recording of users' passwords, history of use and other information; (3) user content provisions with respect to (i) disclaimers of the accuracy and reliability of user content posted on the site, (ii) the grant of a royalty-free worldwide license for the franchisor to use all user content, and (iii) the franchisor's right to store user content and disclose such content under certain circumstances; (4) rules and procedures on the franchisees' use of the intranet (e.g., rules regarding information that may (or may not) be posted and prohibitions on harassing other users, allowing competitors to access the intranet, and uploading, posting or sending "junk mail," "spam," "chain letters," or any other form of solicitation), including the ability to suspend any user's access to the intranet for violating the rules or procedures or the terms of the franchise agreement; (5) provisions with respect to the franchisor's ownership of all software and content used in connection with the intranet; (6) indemnity provisions wherein users agree to indemnify the franchisor for breaches or violations of the terms of use or the franchisor's rules and procedures; (7) disclaimers of warranties by the franchisor; and (8) a limitation of liability provision whereby users agree that the franchisor shall not be liable for any damages resulting from users' use of (or inability to use) the intranet, data breaches, errors, omissions, messages received, information posted, or any other matters relating to the intranet. The agreement also

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[68] *See* Rupert M. Barkoff and Diane Green-Kelly, *Selected Antitrust and Other Issues Involving Franchisee Associations and Purchasing Cooperatives*, ABA 29th Annual Forum on Franchising (2006).

should specify the computer system required by the franchisor for the franchisee to access the internet (and intranet), whether franchisees may create a website or whether the franchisees are limited to creating a webpage on the franchise system's website, as well as include a compliance with laws provision relating to email communication and privacy and data collection.

3. Practical Considerations

Franchisors should consider whether they want to require franchisees to sign a hard copy of its terms of use and online access agreement or require franchisees to sign the terms of use and online access agreement online by utilizing an acceptance click-through. Also, because technology is constantly changing, franchisors should reserve the right to change, modify or discontinue the intranet, any franchise system website and the terms of the terms of use and online access agreement as the franchisor deems appropriate from time to time.

Additionally, as with most of the other ancillary agreements discussed in this paper, a terms of use and online access agreement should contain a cross-default provision so that an event of default under terms of use and online access agreement is considered to be an event of default under the franchise agreement.

R. New Store Opening or Training Agreement

1. Purpose

Each franchise system addresses training in its own manner. In many systems, the franchisor provides all of the training to prospective franchisees and then expects franchisees to train their employees. However, to ensure that each new franchised business opens successfully and all of the franchisor's standards are met, it sometimes is prudent for franchisors to use existing franchisees or their employees that are already well-trained in the franchisor's standards to assist with new franchised business openings and training. This is especially true in locations where there are no company-operated units nearby in which to train a new franchisee entering the system. Franchisees and their employees can be recognized as superior operators by offering them the opportunity to train new franchisees and their employees. This also helps enable the franchisor to maintain a smaller training staff, especially if its network is not growing at a fast pace to keep such a staff busy on a full-time basis. The franchisor must consider the most cost-effective manner by which to train franchisees and their employees, and ensure successful openings of new franchised businesses.

Existing franchisees that provide training and new store opening assistance to newly-signed franchisees expect to be compensated for their time and indemnified by the franchisor for any claims brought by the trainees (e.g., claims of inadequate training alleging that the franchisor's prescribed training program is insufficient). New store opening agreements or training agreements are used to clarify roles and responsibilities between the franchisor and the existing franchisee in this process and to provide the appropriate protections for both parties. This training may occur at the new franchisee's new location, at the existing franchisee's operating location, or at a training location owned or contracted for by the franchisor.

2. Important Terms

The new store opening or training agreement must specify that the franchisor and the existing franchisee are independent contractors. If the existing franchisee is "lending" its employees to train other franchisees' employees, the agreement must clarify that the employees

doing the training remain the employees of the existing franchisee and are not employees of the franchisor, even if the franchisor agrees to reimburse the existing franchisee an amount equal to such employees' wages and benefits for the time spent training. The agreement also should provide the typical indemnification for failure by either party to comply with the terms of the agreement, as well as an indemnification of the franchisor by the franchisee of any claims arising from alleged injuries suffered by the trainees.

3. <u>Practical Considerations</u>

Franchisors that use employees of their existing franchisees to assist with the training and opening of new franchised businesses should limit the amount of direction and oversight provided to these employees to reduce the risk of joint employer liability. Although any joint employer status should be disclaimed in the agreement, as mentioned above, this disclaimer may not be sufficient if the franchisor is the party directing the work done by these employees.

If a franchisor decides to enlist the help of its existing franchisees and their employees in training and opening new franchised businesses, the franchisor should ensure it uses only those franchisees and employees that consistently meet the franchisor's standards, are current in their own training requirements, and are capable of properly training others to operate a franchised business to the franchisor's standards. The mere presence of a franchisee in a geography near a new franchised business is not sufficient, particularly if that franchisee does not exemplify the best operation of the franchised business.

S. <u>Test Agreement</u>

1. <u>Purpose</u>

As franchise systems evolve, the franchisor often changes the products or services offered by the franchise system. This may involve new menu items in restaurant chains from time to time, new linens in hotel chains, or new service models in service-oriented systems. Prior to rolling out any new items for use systemwide, most franchisors obtain customer feedback in limited tests to ensure the new item meets with customer approval and will continue to strengthen the franchisor's brand and the franchise system. As many franchise systems do not have sufficient company-owned units within a particular market, franchisors frequently look to their franchisees to test new products or services on behalf of the system. However, there are inherent risks associated with such tests for both the franchisor and the franchisee, so prudent franchisors use a test agreement to clearly define each party's obligations and limitations.

2. <u>Important Terms</u>

The test agreement should provide a clear description of the product or service to be tested by the franchisee. The agreement should provide for a limited term that is based on the time needed to effectively test consumer reaction to the new product or service in a market, and each party's rights and obligations upon the expiration of the term. If the franchisor determines that the new product or service will not be introduced systemwide, the agreement should require the franchisee to cease using the new product or service at the completion of the test term. If the franchisor decides to introduce the new product or service systemwide, the agreement also should provide that the franchisee will continue to use or sell the product or service, even if changes are made to such product or service by the franchisor prior to the systemwide rollout.

The test agreement may require the franchisee to purchase supplies or products needed to use or make the new product from specific vendors. It also should address how the new product or service will be marketed in the franchisee's market, and each party's obligations for such marketing. If offering the new product or service requires the purchase of additional or new equipment, the agreement should clearly state that the franchisee is required to purchase this new equipment and what happens to the equipment at the completion of the test period if the franchisor elects not to expand the new product or service systemwide. If the franchisor agrees to purchase the new equipment for the franchisee's use during the test period, the agreement should set forth the parties' expectations about the ongoing use of the equipment if the product or service is introduced to the system and whether the franchisee has an obligation to purchase the equipment from the franchisor once the decision is made to offer the new product or service systemwide. The test agreement also must address the impact the test may have on the franchisee. The franchisee should be entitled to retain all revenue generated from the sale of the test product or service, but also should be required to pay royalties to the franchisor for such sales.

Finally, as the test agreement contemplates changes to the franchisor's system, the agreement also should include confidentiality covenants by the franchisee similar to those contained in the franchise agreement. Alternatively, the test agreement can state that the test agreement is subject to the confidentiality covenants contained in the franchise agreement.

3. Practical Considerations

Unless the franchise agreement requires the franchisee to participate in tests when asked by the franchisor (a term not common in most franchise agreements), franchisors will need to convince its franchisees to voluntary enter into test agreements. Therefore, franchisors should consider all aspects of each test to make sure the rights and obligations of each party are clear before the test begins. In drafting a test agreement, franchisors must consider the possibility that the franchisee may lose money as result of its participation in the product or service test. Most test agreements clearly state that the franchisor is not liable to the franchisee for any loss in revenue or increase in costs as a result of the test.

One additional point of consideration pertains to the price charged by the franchisee for a new product or service offered to its customers under a test agreement. The price charged for such test product or service is relevant to gauge overall customer acceptance of the product or service. Customers may love a new food item offered on a menu, but if customers believe the price charged for the product is too excessive, there is a good chance that the new product will not be successful when expanded across the rest of the franchise system. Controlling the price charged by franchisees on products or services, including test products or services, may raise antitrust concerns for the franchisor.[69] Yet random pricing of test products or services by the franchisee will not produce reliable test results on which the franchisor can base a systemwide rollout decision. Some franchisors have clearly articulated in their test agreements that the purpose of the test is to evaluate customers' reaction to the product or service and the price charged for the product. The agreement then includes an acknowledgment by the franchisee of

[69] A discussion of antitrust issues that need to be considered if a franchisor wishes to dictate price to its franchisees is beyond the scope of this paper. *See* Steven B. Feirman and Allan P. Hillman, *Antitrust Issues: Back in Vogue*, ABA 33rd Annual Forum on Franchising (2010); Arthur I. Cantor and Kay Lynn Brumbaugh, *Controlling Franchisee Pricing After Leegin*, ABA 31st Annual Forum on Franchising (2008). *See Also*, Robert T. Joseph, *Antitrust Law, Franchising, and Vertical Restraints*, 31 Franchise L.J. No. 1 (Summer 2011); Quentin R. Wittrock and Jeremy L. Johnson, *Can Franchisors Control Franchisee Prices?*, 28 Franchise L.J. No. 4 (Spring 2009).

its agreement to adopt the franchisor's recommended prices for the test product or service for the test period. There are no reported cases on whether this approach adopted by franchisors will successfully withstand an antitrust claim. Franchisors should discuss possible antitrust issues with their counsel prior to determining how to control pricing of test products or services offered by franchisees.

II. ANCILLARY AGREEMENTS APPLICABLE TO THE END OF THE FRANCHISE RELATIONSHIP

The following agreements include those that pertain to the end (whether due to assignment, termination or expiration) of the franchise relationship. Some of these agreements are signed by franchisees at the commencement of the franchise relationship, such as a Telephone Number Assignment Agreement (discussed under Section III, B below), and others are signed by the parties to document the end of the franchise relationship, such as a Consent to Assignment Agreement or Mutual Termination and Release Agreement (discussed under Sections III, A and III, C below).

A. Consent to Assignment Agreement

1. Purpose

In most franchise systems, the franchisor's prior written consent is required as a condition to the franchisee selling its franchised business and transferring the franchise agreement or interest in the franchisee. The consent to assignment agreement is used to document this consent, which often is subject to certain conditions imposed under the agreement. Although a consent to assignment agreement is most often used in connection with a franchisee's transfer of the franchised business to a third party, franchisors often require a consent to assignment agreement to be signed in connection with an individual franchisee's transfer of the franchised business to a wholly-owned entity.

2. Important Terms

Whether an individual franchisee transfers its interest in the franchised business to a wholly-owned entity or assigns the franchised business to a third-party, the key provisions of the consent to assignment agreement are essentially the same. First, the agreement includes a provision terminating the assignor's rights under the franchise agreement. Second, the agreement includes a provision in which the assignee agrees to assume the assignor's obligations under the franchise agreement. Third, the agreement includes a provision in which the franchisor consents to the assignment. In addition to the three main objectives mentioned above, consent to assignment agreements include all of the obligations of the assignor and assignee that each party much satisfy as a condition to the franchisor consenting to the assignment. Such conditions may include: payment of amounts owed as of the date of the assignment, the assignor immediately ceasing to use the franchisor's trademarks, the assignor immediately returning the franchisor's confidential information, the assignee completing required training, the assignee signing the franchisor's then-current form of franchise agreement and the assignee's owners signing the franchisor's form of guaranty agreeing to guarantee the franchisee's obligations under the franchise agreement. Many franchisors use a consent to assignment agreement as an opportunity to obtain a release from liability from the assignor and the assignee as a condition to the franchisor's consent to the assignment. Lastly, it is recommended for franchisors to restate in the consent to assignment agreement those obligations of the assignor under the franchise agreement that survive the assignor's

assignment of the franchised business, such as any non-competition, non-solicitation and indemnification covenants.

3. Practical Considerations

When drafting a consent to assignment agreement, the drafter should make sure that the assumption provision is broad enough to include all obligations of the assignor under not only the franchise agreement, but under all other agreements relating to the franchised business as well. It also is advisable to include acknowledgments in which the assignee acknowledges that it has received copies of all relevant agreements, and agrees to abide by the terms, conditions, and covenants contained in the agreements. That would include the consent to assignment agreement as well. Further, some franchisors prefer to restate the entire non-competition and non-solicitation covenants from the franchise agreement in the consent to assignment agreement. However, if one elects to do so, it is essential to make sure the covenants are identical to those in the franchise agreement to avoid any ambiguity should the franchisor need to enforce the covenant at some point in the future.

Many franchise agreements include a comprehensive list of conditions which the franchisor may impose when asked by the franchisee to consent to an assignment of the franchised business. However, in those franchise agreements that do not include such a list, franchisors must be careful in choosing the conditions to its consent because if the franchisee and purchaser fail to complete a proposed transfer, franchisees often look to the franchisor for recourse. In one such case, *PCJ Franchising Co., LLC, et al. v. Newsome, et al.*[70], the court denied a franchisor's motion to dismiss the franchisee's counterclaim in which the franchisee argued the franchisor had breached its duty of good faith in its conditions for approval of a proposed buyer of the franchisee's franchised business. The proposed buyer already owned multiple franchises within the franchisor's network, and thus had previously been approved to purchase franchises; however, in this instance, the franchisor conditioned its approval of the transfer on the proposed buyer satisfying burdensome requirements.[71] The proposed buyer ultimately withdrew its offer due to the franchisor's conditions, and the franchisee had to close its business due to financial hardship. The court found that the franchisor's "burdensome requirements on a purchaser they had previously approved for PCJ franchise ownership indicated a lack of good faith,"[72] and the franchisor's motion to dismiss was denied.

B. Telephone Number Assignment Agreement

1. Purpose

When a franchise relationship ends, one of the unforeseen, seemingly minor issues that can arise relates to the contact information for the franchised business - in particular, the telephone number and, increasingly, the email address. Some franchise systems, such as retail and service businesses, have an interest in controlling the telephone numbers and email addresses of the franchised businesses, while other franchisors may simply wish to impart stability on a franchised business while seeking a new franchisee to replace a former franchisee. By requiring franchisees to sign a telephone number assignment agreement,

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[70] Bus. Franchise Guide (CCH) ¶ 14,006 (E.D.N.C. Oct. 24, 2008).

[71] Note that the opinion in the case does not provide examples of the "burdensome requirements".

[72] *Id*. at 3.

franchisors can require franchisees to assign the franchised business's telephone number and email address to the franchisor upon the expiration or termination of the franchise agreement, and maintain some control over the telephone numbers for the franchised business even if the franchise changes hands. The justification for the conditional assignment is that changing the telephone number creates the potential for confusion of customers and the ability of the former franchisee to profit from the franchisor's trademarks and the franchisor created goodwill in the phone number by its advertising of the phone number in connection with the franchisor's trademarks.

2. Important Terms

A telephone number assignment agreement should be clear in its conditional nature. The franchisee assigns to the franchisor the telephone number, telephone listing, and if applicable, the email address, but will retain a limited right to use the telephone number and email address during the term of the franchise relationship until the expiration or termination of the franchise agreement. The agreement should include the telephone number and listings (and email address, if applicable), and the agreement of the franchisee to execute any additional third-party forms that may be necessary to effect the assignment. The effective date of the assignment should be left blank so that the franchisor can fill it in on the actual expiration or termination date of the franchise agreement.

3. Practical Considerations

Rather than waiting until the relationship between the franchisor and franchisee deteriorates and requesting the franchisee to complete the telephone number assignment agreement at that time, franchisors should require franchisees to sign a telephone number assignment agreement at the outset of the franchise relationship. When drafting the telephone number assignment agreement, franchisors should consider addressing which party is responsible for notifying the telephone company, directory listing and any email directory agencies, although this duty is usually imparted on the franchisee.

Further, as is the case with all ancillary agreements, it is important for franchisors to ensure that the language in the franchise agreement is consistent with the terms of the telephone number assignment agreement. One case highlighting this importance is *Brenco Enterprises, Inc. v. Takeout Taxi Franchising Systems, Inc.*[73] In *Brenco Enterprises*, the court was forced to analyze conflicting language in a telephone number assignment agreement and a telephone assignment provision in the franchisor's franchise agreement because the franchisees contended that they owned the telephone numbers for the franchised businesses upon the expiration of the franchise agreement. The issue was that the provision in the franchise agreement stated that the franchisee must notify the telephone company and all telephone directory listing agencies upon the <u>termination or expiration</u> of its right to use the telephone number and listing, while the telephone number assignment agreement omitted the word "expiration."[74] Although the court found in favor of the franchisor holding that there was nothing in the telephone number assignment agreement that reflected "any mutual intent for the exhibited Assignment Agreement to waive, expand, or diminish rights previously granted under

[73] No. 177164, 2003 WL 21659422 (Va. Cir. May 2, 2003).

[74] *Id*. at *5.

the franchise agreement,"[75] the inconsistent language between the agreements created an ambiguity that had to be resolved.

C. Mutual Termination and Release Agreement

1. Purpose

Sometimes a franchisor and franchisee wish to terminate their franchise relationship before the expiration of the franchise agreement. A mutual termination agreement is an agreement effectuating the termination of not only the franchise agreement, but also all other ancillary agreements between the parties. The reasons for mutual termination vary, and can range from a consensual termination due to the financial hardship of a franchisee to a way for a franchisor to avoid costly litigation when dealing with a rocky franchise relationship. Mutual termination and release agreements can be an efficient and practical way for the parties to bring the franchise relationship to an end, identify any ongoing obligations that may survive termination, and protect the interests of both the franchisor and the franchisee going forward by each obtaining a release of liability from the other.

2. Important Terms

The mutual termination and release agreement should include the effective date of termination; the conditions the parties must satisfy in order for the termination to become effective (e.g., payment of amounts owed as of the date of the termination); the requirement for the franchisee to immediately cease using the franchisor's trademarks upon termination; the requirement for the franchisee to immediately return the franchisor's confidential information; and mutual releases from liability, however, if the franchisor is agreeing to terminate the franchise relationship as an accommodation to the franchisee, the franchisor may want to limit the release to a one-sided release by the franchisee. The mutual termination and release agreement also should re-state those obligations of the franchisee and its owners under the franchise agreement that survive the termination of the franchise agreement, such as any non-competition, non-solicitation and indemnification covenants. Franchisors also may want to include a non-disparagement provision; however, if the provision is mutual, franchisors must be sure to inform their sales personnel and other appropriate employees, as well as comply with the related disclosure obligations in Item 20 of the FDD.

3. Practical Considerations

Mutual termination and release agreements typically include a broad release of liability from the franchisee and the franchisee's owners. In order to receive an effective release from the franchisee's owners, franchisors must remember to require the owners to execute the mutual termination and release agreement in their individual capacity (in addition to executing the agreement on behalf of the franchisee entity). Although many mutual termination and release agreements are negotiated by the parties, it is not unheard of for a franchisee to later try to bring an action against the franchisor in an attempt to invalidate the termination agreement (usually if the termination agreement contains a release by the franchisee or a non-competition or non-solicitation covenant). Fraud in the inducement and duress are common arguments in these types of actions. As an example, in *Kinnard v. Shoney's, Inc.*,[76] the court explored the

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[75] *Id*. at *6.

[76] 100 F.Supp.2d 781 (MD.Tenn. 2000).

franchisee's claim that it signed a termination agreement and release agreement (among other documents) under economic duress. By the time the franchisor provided the franchisee with a termination agreement, the franchisee argued that even though it was represented by counsel, it ultimately had no choice but to sign the termination agreement because it was already past due on various accounts with the franchisor for over a year. In order to establish a claim of economic duress, the pressure must be such that it will "overcome the mind and will of a person of ordinary fitness."[77] Applying that analysis, the court held that the franchisee was not under economic duress at the time it signed the mutual termination agreement because the franchisee had over a year to consider the mutual termination agreement, the franchisee was represented by counsel, and the franchisee made many admissions regarding its consideration of the termination agreement.

D. Purchase Agreement for Fixtures (at Expiration or Termination of Franchise)

1. Purpose

Many franchise agreements grant the franchisor an option to purchase certain assets of the franchised business upon the termination or expiration of the franchise agreement. Franchisors may want to exercise this right if the franchisor is concerned about its proprietary equipment falling into the wrong hands (e.g., a competitor) or the franchisee discarding signage, furniture and/or fixtures featuring the franchisor's trademarks or trade dress that are valuable to the franchisor and the brand. If the franchisor exercises its right to purchase certain assets of the franchised business it will need to enter into a purchase agreement with the franchisee.

2. Important Terms

The purchase agreement should specify: (1) a purchase price, which often is the result of a prescribed formula under the franchise agreement (e.g., book value or a percentage of cost depending on the age of the asset); (2) a closing date and date for the delivery of the assets; (3) the party responsible for the payment of any sales, transfer or transaction taxes, as well as an allocation of the purchase price among the assets being purchased for tax purposes; (4) a list of the assets being purchased (including a Bill of Sale, which is generally an exhibit to the purchase agreement); and (5) the party responsible for any liabilities associated with the assets being purchased. The purchase agreement also should include all of the representations and warranties typically given by the seller of equipment, including, that the assets are free and clear of all liens and encumbrances, that the franchisee has good marketable title to the assets, that the assets are in good condition, normal wear and tear excepted, and that the transaction will not conflict with or violate any provision of the franchisee's organizational documents or other agreements with third parties. Lastly, it is important for the purchase agreement to include indemnifications by the buyer and seller for a breach or violation of any of the representations, warranties, covenants or obligations contained in the purchase agreement or any other transaction documents between the parties.

3. Practical Considerations

The assets subject to the purchase agreement may not always be in the most favorable condition; however, it might not be much of a concern for the franchisor as long as the

[77] *Federal Deposit Ins. Corp. v. Ramsey*, 612 F.Supp. 326, 328 (E.D.Tenn. 1985).

franchisor regains possession of the assets. Also, the sale of fixtures, if combined with other assets, may trigger bulk sales notification requirements or other state-specific tax issues, so franchisors should consult with their legal or tax advisors to ensure compliance with any applicable state tax requirements. Lastly, some states' franchise relationship laws specifically address franchisor buyback obligations. Those states' laws differ as to the circumstances under which a franchisor must buy back items from the franchisee upon termination, as to what items must be purchased, and as to the sales price for the items.[78] Therefore, even if the franchisor elects not to exercise its option to purchase the assets of the franchised business, it still may be required to do so under applicable law.

IV. CONCLUSION

Ancillary agreements can be essential to a franchise system because no franchise agreement can incorporate every term necessary to clearly define a successful relationship between the franchisor and franchisee over the life of the franchise. As illustrated in this paper, these agreements arise at the formation of the franchise relationship, during the term of the franchise relationship (and are needed as the franchise system evolves), and at the end of the franchise relationship.

When preparing ancillary agreements, one should remember to keep in mind that the use of an ancillary agreement may result in the need to disclose a prospective franchisee with an FDD (see Section II, A above for a discussion of letters of intent and other preliminary agreements), the terms of the ancillary agreement may need to be disclosed in the FDD, and some ancillary agreements may need to be attached to the FDD. Careful attention also must be paid to the drafting of these agreements to ensure the terms of the ancillary agreements do not unintentionally contradict the terms of the franchise agreement.

[78] *See Defaults and Terminations: An Unfortunate Reality of a Challenging Economy*, Joseph J. Fittante Jr. and Meredith Bauer, 28-SPG Franchise L.J 214 at 218, Spring 2009.

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