AMERICAN BAR ASSOCIATION

FORUM ON FRANCHISING

ESSENTIALS OF FRANCHISING

JULY 10, 2000

NEW YORK, NEW YORK

DRAFTING EFFECTIVE FRANCHISE AGREEMENTS

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This is an updated version of a paper originally entitled “Laying The Keel: Drafting Effective Franchise Agreements”, which was part of the program materials from the American Bar Association’s Annual Forum On Franchising in Hilton Head Island, SC, October 29-30, 1992

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INTRODUCTION

A Franchise is a Creature of Contract

The archetypical franchise offers an entrepreneurial-minded person an opportunity to own his or her own business while becoming part of a larger system that will provide instant market acceptance and greatly simplify the process of starting up a new business. But what is this new business? What is it that the franchisee owns?

A franchise is a creature of contract; it is defined by the franchise agreement. The extent of the franchisee's "ownership" interest in the franchise is defined in particular by the provisions dealing with the scope of the grant, transfers, termination and renewal.

Franchises come in endless varieties. One franchise may be granted for a fixed term at a specific location with a requirement that the franchisee surrender the premises to the franchisor upon termination, and have no renewal rights. Another may allow the franchisee to continue in business after the expiration or termination of the agreement at the same location under a different name and identity.

While many franchisees are individual entrepreneurs, some franchisees are corporations, some own a number of franchises, and some are larger and more profitable than the franchisor. While many franchisors require that the franchise location be devoted solely to the franchised products or services, some franchisors allow franchisees to sell other products and services, and to enter into other franchise agreements for the same location. While some franchisors own the premises at which the franchised business is located, in other cases, such as many hotels, the franchisee owns the premises and may simply enter another franchise system after one franchise agreement ends.

In each of these systems, the relative values of the franchised business and that portion of the business that is independent of the franchise will vary. Franchisors must be sensitive to the fact that the structure of the system will greatly influence the franchisee's incentive to devote money and effort to develop the franchised business. The more value that accrues to the franchisee, the more the franchisee will be willing to invest.

Drafting in the Context of the Franchise Relationship Laws

Because of their importance to the economics of the franchise relationship, it is not surprising that contractual provisions dealing with the scope of the grant, transfers, termination and renewal have provoked a great deal of controversy over the years. Encroachment, transfer

prohibitions, unjust terminations, and refusals to grant renewal rights are also the subjects of the franchise relationship laws of several states.[1] These laws may limit or simply complicate the enforcement of the agreement, or impose requirements not contained in the agreement.

Because the franchise relationship laws can impede the uniformity that franchisors like to have in their agreements, one approach would be to draft the agreement to comply with the requirements of the toughest state franchise relationship laws. This enables the franchisor to have an agreement that is uniformly enforceable throughout the country. Not all franchisors take this approach. According to one source, approximately 4% of franchise agreements permit the franchisor arbitrarily to terminate, and approximately 7% permit the franchisor to refuse to renew or to permit the transfer of the franchise.[2] The relationship laws would not permit such arbitrary actions by the franchisor.

An agreement drafted to comply with the requirements of the toughest state franchise relationship laws is likely to be or be perceived as a fair agreement. This is important because franchise agreements are not like other business agreements. In the give and take of a typical negotiated business agreement, the first draft of an agreement will be one-sided in favor of the drafter's client, and will then be changed in the course of negotiation, ultimately reflecting the relative strengths of the parties. The model in franchising is radically different. A franchise system is planned by the franchisor and presented as a package to franchisees uniformly in the form of a franchise offering circular. The attorney for the franchisor will draft the agreement and offering circular with the interests of the franchisor in mind. The drafter must remember, however, that the franchisor will be extremely reluctant to negotiate changes in the standard franchise agreement.[3] This compels the franchisor's attorney to look at the agreement from the point of view of both the franchisor and franchisee. Because the franchisee is not involved in the drafting, the franchisor's attorney might consider with the client positions favorable to the franchisee that would not be seriously considered in a fully negotiated agreement.[4]

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[1]*See* "Franchise Relationship Laws: A Minefield for Franchisors", Thomas M. Pitegoff, 45 THE BUSINESS LAWYER 289 (Nov. 1989), reprinted in the American Bar Association's BUILDING FRANCHISE RELATIONSHIPS (1996).

[2]Statement of Jeffrey E. Kolton before the U.S. House of Representatives, Committee on Small Business, June 17, 1992. *See* "Dispute Grows Over True Rate of Franchisee Failures," Wall Street Journal, July 3, 1992, p.B2.

[3]Negotiation may require the franchisor to amend the offering circular for subsequent offerees. *See* Cal. Admin. Code title 10 §310.100.2; Ill. Franchise Disclosure Act of 1987, title 14 §200.114; Wisconsin Franchise Investment Law, Wis. Stat. §553.31(3). On the other hand, negotiation is required under the Virginia Retail Franchising Act. Va. Code §13.1-565(b).

[4]*See* "Can a Franchise Agreement be Both Fair and Effective?", by Lewis G. Rudnick and Donald L. Weaver, 1991 Forum on Franchising.

Aside from the advantages of having uniformly enforceable agreements, the franchisor's business incentive to be fair is simply that a fair agreement will sell more franchises than a one-sided agreement. A new franchisor trying to sell its first franchise must be especially mindful of the salability of the agreement. A powerful, well-known franchisor may be able to sell franchises with less "fairness" in the agreement because it has a proven record of profitability. Even for large franchisors, however, fairness makes for good public relations. Franchise agreements are public documents, and larger franchise systems are subject to more public scrutiny.

While fairness addresses the substance of the agreement, the drafter can also make cosmetic changes in the agreement that will enhance its appeal to potential franchisees. To protect the franchisor, it is not necessary to say, for example, that the franchisor has the right, "in its sole and unfettered discretion," to do this or that. It suffices to say that the franchisor has the right to do this or that. In other cases, it may be possible to make rights mutual without really giving anything up.

A fair agreement in both form and substance will not only allow for uniformity, sell more franchises and enhance the franchisor's image. It will also avoid disputes later on and put the franchisor in a better light when disputes do arise. In that sense, a fair agreement is a long term investment.

Fairness in drafting, then, is a marketing and public relations tool, and the first line of attack or defense in the event of a dispute.

SCOPE OF THE GRANT

The extent of the franchisee's interest is defined in large part by the scope of the grant with respect to the territory, the market or channels of distribution, the goods or services, and the extent to which the grant is exclusive.

Exclusive Territory

Frequently, the franchisor will grant an exclusive territory or a radius within which the franchisor will not establish a competing outlet. Exclusivity gives the franchisee an incentive to market in the territory, knowing that this marketing will maximize the franchisee's earnings and not that of neighboring franchisees. An exclusive territory also implies an obligation on the part of the franchisee to exploit the territory.

Some franchise agreements do not provide for territorial exclusivity, but only for the grant of a franchise at a particular location. This can be a source of tension between the franchisor and franchisee. When the franchise agreement provides no territorial protection or a

small territory, the franchisor may be tempted to grant other franchises that may be close enough to compete. The franchisees may object, because the competition may reduce their sales or profits. However, the franchisor may benefit from the total aggregate increase in sales by the competing franchises.

Encroachment

Some franchise laws prohibit encroachment by the franchisor on the franchisee's exclusive territory. For the most part, these laws only apply where the agreement provides for an exclusive territory, meaning that the franchisor must comply with the terms of the franchise agreement. *Rado-Mat Holdings, U.S., Inc. v. Holiday Inns Franchising, Inc., Bus. Franchise Guide (CCH) ¶9975 (1991); Eichman v. Fotomat Corp.*, 871 F.2d 784, Bus. Franchise Guide (CCH) ¶9352 (9th Cir. 1989). Only the Iowa franchise law has a generally applicable prohibition against encroachment. Bus. Franchise Guide (CCH) ¶2002. Section 6 of this law provides that if a franchisor seeks to establish a new outlet or company-owned store within an "unreasonable proximity" of an existing franchisee, the existing franchisee, at the option of the franchisor, must have either a right of first refusal with respect to the proposed new outlet or a right to "compensation for market share diverted by the new outlet." As applied to food establishments, the term "unreasonable proximity" includes the shorter of a three-mile radius or a radius comprising a population of thirty thousand people. It is not at all clear what an "unreasonable proximity" is with respect to other types of franchises in Iowa.

The issue of encroachment can arise even outside of Iowa when the agreement does not provide for territorial exclusivity. Some franchisors with well-established marks are strong enough that they need not offer territorial exclusivity in the franchise agreement. Such franchisors may grant rights to a specific location rather than a territory. Franchises of such franchisors may be so desirable that the franchisees are willing to rely on the franchisors' good faith. The general rule is that the courts will not stop a franchisor from establishing another franchise or company-owned outlet near the location of the first franchise when the agreement does not provide for territorial exclusivity. The express terms of the franchise agreement will usually prevail over the franchisee’s claim of a breach of the implied covenant of good faith. *See Burger King Corp. v. Weaver*, 169 F.3d 1310 (11th Cir. 1999).

In extreme cases, however, the franchisee can argue that the franchisor does not have the right to destroy the franchisee's right to enjoy the fruits of the contract. *See Scheck v. Burger King Corp.*, Bus. Franchise Guide (CCH) ¶9760 (S.D. Fla. 1991). *See also In Re Vylene Enterprises, Inc.,* 90 F.3d 1472 (9th Cir. 1996). In the most extreme case, a franchisor that saturates the market in order to drive franchisees out of business may be in violation of the antitrust laws. *See Photovest v. Fotoma*t, 606 F.2d 704 (7th Cir. 1979), *cert. denied*, 445 U.S. 917 (1980).

Systemwide Merger

Competition among franchisees within one system may also arise when the franchisor acquires a competing franchise system. The franchisor might anticipate this eventuality by retaining the right to sell competitive goods or services identified by other trademarks in the franchisee's territory. This might be limited to instances where the franchisor acquires or merges with or is acquired by a competing business, a portion of which is located in the franchisee's territory. The franchise agreement might provide that in the event of such a merger or acquisition, the franchisor will not change the identity of the competing business to that of the franchisee. The franchisor might also agree that, in the event of such a merger, the franchisor will not give any competitive advantage to a competing franchise in the exclusive territory.

Another approach might be for the franchisor to reserve the right to convert the acquired business to the franchisor's format and identity either as a company-owned outlet or as a franchised location. The franchisee may object to this. The conversion of the site to the franchisor's identity may pose greater competition than that posed by the same store using a different identity. The franchisor's brand identity may be stronger and it may difficult for the two franchises to differentiate themselves. In one recent case, for example, a franchisee successfully alleged constructive termination on the basis that the franchisor's pricing for its products to the acquired dealers in its territory made it impossible to compete. The court granted damages for the franchisee's unrecouped expenses. *Mankato Implement, Inc. v. J.I. Case Co.,* Bus. Franchise Guide (CCH) ¶9947 (D. Minn. 1991).

Where the acquired location is owned by the franchisor and not franchised, the franchisee might be given the right to purchase the acquired location on the same terms as the franchisor, at that portion of the franchisor's acquisition cost allocated to the outlet.

Reserving Markets to the Franchisor

Usually, exclusivity means that the franchisor will not franchise another location and will not open a company-owned store in the territory. In addition, it may mean that the franchisor will not sell its products directly to other retailers or wholesalers in the territory. Where the franchisee is selling consumer products under the franchisor's brand, the franchisor may want to reserve the right to sell directly by mail order, or to department stores and other national or regional customers. This type of restriction will be upheld if it is reasonable. For example, Pillsbury was permitted to sell Haagen-Dazs ice cream in supermarkets and convenience stores when its franchise agreement with ice cream parlor franchisees expressly reserved this right. *Rosenberg v. Pillsbury Co.*, 718 F. Supp. 1146, Bus. Franchise Guide ¶9445 (S.D.N.Y. 1989).

The franchisor should also reserve the right to use and license the trademarks to others for different uses, and to sell other products in the franchisee's territory under different trademarks, as illustrated in the case of *So Good Potato Chip Co. v. Frito-Lay, Inc.*, 324 F. Supp. 280 (E.D. Mo. 1971), *aff'd* 462 F.2d 239 (8th Cir. 1972). The plaintiff in that case had a license from Frito Lay to manufacture and distribute "Fritos" corn chips in a defined territory. Frito Lay introduced "Doritos", "Fandangos" and "Intermission" corn chips into the licensed territory. The

licensee then sought an injunction enjoining Frito Lay from manufacturing, selling and distributing any corn chips within the licensee's territory. The license agreement specifically prohibited the licensor from selling "Fritos" corn chips in the licensed territory. The licensee argued that there was an implied covenant not to manufacture or sell competitive products. The court held that the products being sold by Frito Lay were not competitive with "Fritos", and denied the injunction. The Eighth Circuit Court of Appeals affirmed, holding, among other things, that since the license agreement prohibited the sale of "Fritos" corn chips, it was not silent on the subject. The court would not imply a negative covenant where the parties had addressed the issue in the agreement. The lesson of this case is that a clear agreement might have avoided costly litigation.

Extraterritorial Sales

Should the franchisor prohibit the franchisee from advertising or selling outside the exclusive territory? Should the franchisee be permitted to accept orders from outside the territory? Should the agreement provide only for an "area of primary responsibility"?

There is no antitrust restriction on prohibitions against sales outside the exclusive territory, as long as the prohibition is reasonable. *Continental T.V., Inc. v. GTE Sylvania, Inc*., 433 U.S. 36 (1977). Therefore, the question whether to include such prohibitions is a business and marketing question. Will most of the advertising be national? In a hotel chain, for example, a prohibition against sales outside the franchisee's territory would not be meaningful. Enforcement of prohibitions against sales by the franchisee outside its exclusive territory can also be costly and difficult. Allowing franchisees to compete with one another eliminates an enforcement problem for the franchisor. Accordingly, the franchisor should consider whether such a restriction is necessary or advantageous from a business point of view.

Defining the Goods or Services

It is also important for the franchisor to be very clear on the types of goods or services that the franchisee is permitted to sell in the franchised shop or territory. If the scope of the grant is too broad, the franchisor may have trouble selling other types of franchises or other types of goods or services in the territory.

Conversely, the franchisor should be very clear about limitations on the types of goods and services the franchisee is permitted to sell. Will the franchisor be the sole source of supply? Must other sources of supply be approved by the franchisor? Will the franchisee be permitted to sell only certain types of products or only certain brands of products?

Protecting Development

By granting exclusive territories, franchisors run the risk that some franchisees may be content with an "adequate" return on investment, and will not have the drive to develop their

territories to the extent that the franchisor would like. The franchisor must be careful not to tie up exclusive territories with this type of franchisee. One approach would be to link the size of the exclusive territory to specific performance goals. If the performance goals are not met, the franchisor might reduce the size of the exclusive territory or eliminate exclusivity altogether, without terminating the agreement.

Also, the franchisor should allow for changes in demographics. If a territory is granted for twenty years on the assumption that the market is of a certain size, but it changes dramatically in ten years, the franchisor may want the right to grant another franchise in the territory.

Instead of granting exclusivity, then, the franchisor might want to consider granting only options or rights of first refusal on additional franchises within a specified proximity or limiting the number of franchises in the territory.

The franchisor is also better protected by offering a short term agreement with no right to renewal or a limited right to renewal, as discussed below.

TERM AND RENEWAL

The term of the franchise agreement and renewal rights directly affect the value of the franchise. The term of most franchise agreements ranges from five to twenty years, and most franchise agreements grant to the franchisee the right to renew the agreement under certain terms and conditions.

Term

In order to determine the appropriate initial term for a particular franchise system, the franchisor must consider a number of factors that relate to the business plans of the franchisor as well as the marketability of the franchise. In essence, the duration must meet the goals, objectives and desires of both the franchisor and the franchisee.

A short term can maximize the franchisor's flexibility. If the franchisee is not suited to the system, the franchisor may want to look for a better franchisee upon the expiration of the agreement. The franchisee, on the other hand, often wants the security of a longer term. At a minimum, the franchisee will want to be sure that the initial term is long enough to enable the franchisee to recoup his or her initial investment and obtain a reasonable rate of return on such investment. Some franchisors may prefer a long term to discourage franchisees from leaving the system and operating competing businesses without making royalty payments, particularly in those states in which the franchisor will be unable to enforce post-termination covenants against competition.

The shorter the term, the less the franchisor will be able to charge as the initial fee. One reason is that the value of a short term agreement is simply less than that of a long term agreement. Also, upon renewal, the franchisee may be required to make a substantial investment to upgrade and refurbish the premises. The shorter the term, the sooner the franchisee may be required to upgrade and refurbish. The franchisor may have to pay for this flexibility with a lower initial fee. A low fee may be attractive to some prospective franchisees. It may be especially helpful to a franchisor in an unknown market or in a new franchise system.

Cutting across these considerations is the competition factor. The prospective franchisee will be looking at the term offered by competing franchise systems per investment dollar. The competition may be franchises in the same business or in completely different businesses, depending on whether prospective franchisees are looking to enter the type of business being franchised or whether they are looking for the appropriate franchise to buy.

Renewal and Extension

The term "renewal" can have a number of possible meanings. For purposes of this paper, renewal means adding another term after expiration, for such length of time and in such manner as the agreement specifies, on the same terms and conditions as the expiring term. By "extension", we mean the right to enter into a new agreement upon the expiration of the term or renewal term of the agreement. The new agreement would be on the terms then being offered to new franchisees.

While some franchise agreements do not allow for renewal or extension, most allow for one or the other or both. The least desirable approach from the franchisor's point of view would be an agreement that gives the franchisee the right to renew the agreement from term to term indefinitely, because it would lock the franchisor into one form of agreement as long as the franchisee desires. An agreement that allows either party to terminate at the end of any term is better for the franchisor, but is not common in franchising because of the need to take the initial fee into consideration. More typically, the agreement will be for one term, with perhaps one renewal term, with a right of extension if the franchisee so desires, upon the terms of a new franchise. Variations on this approach might include offering an extension for one half of the initial fee then being charged to new franchisees, or for no initial fee at all.

Conditions for Renewal or Extension

The grant of an extension is commonly made subject to certain conditions. Renewals may be made subject to similar conditions. For example, the franchisor may require that the franchisee:

(1) give notice of his or her election to extend;

(2) be in compliance with the terms of the franchise agreement during the initial

term;

(3) do all remodeling, modifications, upgrades and investments needed to ensure that the franchise is in compliance with the franchisor's then current standards and specifications;

(4) execute the franchisor's then-current form of franchise agreement and ancillary documents which may provide for different or higher royalties and advertising fees as well as other material changes;

(5) relocate if the lease terms are not satisfactory or the existing location is no longer suitable;

(6) obtain an extension or renewal of the lease if the existing location continues to be suitable;

(7) pay a renewal fee; and

(8) execute a general release.

Some franchisors charge another full franchise fee upon renewal or extension. Others simply charge costs incurred in connection with the renewal or extension. Still others forego the requirement of a renewal or extension fee altogether.

The franchisor might also want to reserve the right not to renew or extend the agreement in the event that the franchisor, in its discretion, chooses to withdraw from the market area in which the franchise is located. The franchisor might want to draft this type of provision in accordance with Section 20025(e) of the California Franchise Relation Act, which provides that the franchisor may refuse to renew if it withdraws from distributing its products or services through franchises in the geographic market served by the franchisee provided that (1) the franchisor does not seek to enforce a post-termination covenant against competition; (2) the franchisor's failure to renew is not for the purpose of transferring the franchised business to the franchisor's account; and (3) if the franchisor sells or transfers the franchisee's business premises occupied previously by the franchisee, the franchisee is given a right of first refusal.

Another approach to extension is that used by McDonald's. McDonald's gives its franchisees an opportunity to cure any deficiencies so that a new franchise may be offered. If the franchisee does not correct the deficiencies within a specified period, McDonald's sends a notice of nonrenewal well in advance of expiration. During this period prior to expiration, the franchisee has the right to sell the franchise to an approved successor franchisee, who will buy the franchise for the remainder of the term plus a new 20-year term. *See Roseli, Inc. v. McDonald's Corp.*, Bus. Franchise Guide (CCH) ¶8870 (D. Neb. 1986).

Single Term Agreements

Some franchise agreements are for one single term and do not allow for renewal or extension. At the end of the term, the parties will either enter into a new agreement or the relationship will expire. This type of agreement is very similar to a commercial office lease for a fixed term with no renewal right. An agreement of this type may make sense in franchising where the franchisor allows the franchisee to continue in business at the same location under a different identity after the expiration of the agreement. The agreement will be worth far less to a franchisee when there is a post-term noncompete requirement.

Can a franchisor choose to refuse to renew or extend the agreement at the expiration of a single term agreement? In the absence of any franchise relationship law, it is likely that a court would enforce the agreement in accordance with its terms and not impute a right to renewal or extension. This follows the basic contract principle of protecting the justified expectations of the parties and the general reluctance of courts to rewrite contracts. Requiring renewal or extension essentially results in a perpetual agreement. A number of courts have allowed agreements of indefinite duration to be terminated on reasonable notice because of a policy against perpetual agreements. *See, e.g.*, *U.S. Surgical Corp. v. Oregon Medical & Surgical Specialties, Inc.*, Bus. Franchise Guide (CCH) ¶7580 (S.D.N.Y. 1980). *See also, Mobil Oil Co. v. Rubenfeld*, 370 N.Y.S.2d 943 (App. Div. 1975); *Cornitius, Inc. v. Wheeler*, 556 P.2d 666 (Or. 1976). It is essential, however, that the contract be clear on this point. In *Atlantic Richfield Co. v. Razumic*, 390 A.2d 736 (Pa. 1978), the court concluded that the franchisor could not refuse to renew unless the franchise agreement expressly reserved a right on its behalf to do so. *See also Shell Oil Co. v. Marinello*, 307 A.2d 598 (1973) (holding that in light of the enactment of the New Jersey franchise relationship law after the case was filed, there existed in New Jersey a strong public policy against refusal to renew).

Statutory Restrictions Regarding Term and Renewal

Some states require the franchisor to permit renewal unless the franchisor has "good cause" not to renew.[5] It is likely these laws would allow an agreement that clearly and explicitly provides that there will be no renewal to expire in accordance with its terms, although this is not at all certain. Courts have not squarely faced this issue, probably because franchisors, as a practical matter, allow good franchisees to renew and there is always arguable cause for nonrenewal in other cases.

A franchisor can refuse to extend a franchise agreement, even under the Wisconsin Fair Dealership Law, if the franchisee does not accept the new agreement that contains reasonable and nondiscriminatory changes, when the agreement allows the franchisor to require the franchisee to sign the then-current agreement as a condition to renewal. *Ziegler Co. Inc. v. Rexnord, Inc.*, 433 N.W.2d 8, Bus. Franchise Guide (CCH) ¶9317 (Wis. 1988). It is also

[5]*See* note 1 *supra*.

permissible under the Puerto Rico dealership law to refuse to extend if the franchisee does not give the required notice of his intention to extend. *Nike Int'l Ltd v. Athletic Sales, Inc*., Bus. Franchise Guide (CCH) ¶9297 (D.P.R. 1988).

Some state franchise relationship laws also provide notice periods for nonrenewal. In the state of Washington, for example, a franchisor must give one year's notice of its intent not to renew the agreement.

TRANSFER OF THE FRANCHISE

Provisions that control the ease with which a franchisee may sell or assign the franchise may have an impact on the value of the franchise. Obviously, a franchise that the franchisee can freely transfer will be worth more to a franchisee than one that allows the franchisor unreasonably to withhold its consent to a transfer. While case law and legislation in some states limit the right of franchisors to withhold such consent unreasonably in certain cases, there are a variety of approaches that a franchisor may take on the subject of transfers by the franchisee. Transfers by the franchisor should also be addressed in the franchise agreement, and this can be done in several ways.

Absolute Prohibition Against Transfer by the Franchisee

If the agreement is silent on the issue of whether transfers may be made without the consent of the franchisor, the requirement of consent may be implied on the basis that the franchise agreement is a contract for personal services. *See Berliner Foods Corp. v. Pillsbury Co*., 633 F. Supp. 557, Bus. Franchise Guide (CCH) ¶8566 (D. Md. 1986). When a franchise agreement provides only that the franchisor's consent to a franchisee transfer is required, without more, state statutes and courts will generally impose a reasonableness or good faith standard. *See Larese v. Creamland Dairies, Inc*., 767 F. 2d. 716, Bus. Franchise Guide (CCH) ¶8398 (10th Cir. 1985). *See also Prestin v. Mobil Corp*., 741 F.2d 268, Bus. Franchise Guide (CCH) ¶8217 (9th Cir. 1984). Franchisors may impose significant conditions on transfer, *e.g.,* that the franchisee must execute a general release in favor of the franchisor as a condition for transfer. *See Franchise Management Unlimited, Inc. v. America's Favorite Chicken*, 561 N.W.2d 123, Bus. Franchise Guide ¶11,101 (Mich. Ct. App. 1997).

A provision that allows the franchisor arbitrarily to withhold its consent from a proposed transfer would put the franchisee at virtually the same disadvantage as a provision that completely prohibits transfer. Some case law indicates that a clear and unequivocal provision prohibiting transfers of any kind may be upheld. *See, e.g., C. Papas Co., Inc. v. E & J Gallo Winery*, 610 F. Supp. 662, Bus. Franchise Guide (CCH) ¶8378 (E.D. Cal. 1985), *aff'd* 801 F. 2d 339, Bus. Franchise Guide (CCH) ¶8671 (9th Cir. 1986); *Crow v. Mobil Oil Co*., Bus. Franchise Guide (CCH) ¶7793 (C.D. Cal. 1981).

While a clear contractual provision prohibiting the franchisee from transferring its interest in the franchise or the franchise agreement may be enforceable as a matter of contract law, it would not be enforceable under some state franchise relationship laws. These laws may limit the withholding of consent to transfer to those cases in which the franchisor has a material reason relating to the character, financial ability or business experience of the proposed transferee, the unwillingness of the proposed transferee to agree to comply with all franchise obligations, or the failure of the franchisee or proposed transferee to pay any sums owing to the franchisor and to cure any default.

Regardless of its enforceability, the outright prohibition of transfers raises issues of fairness and is generally unnecessary, since franchisors have other, far less draconian ways of protecting the integrity of their franchise systems, such as the right of first refusal, discussed below. Moreover, a franchise agreement that prohibits transfers under any circumstances will have little market value to prospective franchisees.

Restrictions on Transfer by the Franchisee

Franchise agreements typically contain provisions that limit, but do not prohibit, the transfer or assignment of (1) the franchise agreement or any interest in the agreement, (2) all or substantially all of the assets of the franchisee's business, or (3) any portion of the franchisee entity.

The interests of the franchisor and franchisee obviously differ on this issue. The franchisor is concerned with the transferee's qualifications, its commitment to the franchise system, and the image of the franchise system. The franchisor has an obligation to its franchisees throughout the system to ensure that all franchisees meet the standards necessary for success. If one franchisee provides poor service and product quality, and projects a poor image, this will reflect badly on all other franchises in the system. On the other hand, franchisees are concerned about their ability to freely sell, assign or otherwise transfer their businesses, in which they have invested considerable time, effort and money.

Agreements will typically define the term "transfer" broadly as the voluntary, involuntary, direct or indirect assignment, sale, gift or other disposition by the franchisee entity or any of its owners of any interest in: the agreement, the ownership of the franchisee entity, or the franchised business. It may also be advisable to include, by way of illustration, a list of typical events of "transfer" for which the transfer provisions of the agreement will apply. These may include (1) stock transfers or transfers of partnership interests, (2) merger, consolidation or issuance of additional shares representing a new ownership interest in the franchisee entity, (3) any sale of stock or security convertible to stock in the franchisee entity, or (4) the transfer of any interest in the franchisee entity or business due to divorce, death, disability, insolvency, corporate or partnership dissolution or otherwise by operation of law.

The drafter may want to include in the franchise agreement a list of certain types of "pre-approved" transfers that will not be subject to the standard transfer procedures required under the agreement. Such exceptions may include: (1) transfers of interest between principals of the franchisee entity, (2) transfers for estate planning purposes, and (3) change in the business form of the franchisee, *e.g.,* from individual to corporate status, so long as the same parties are controlling the franchisee entity. Even though such excepted transfers or changes will not be subject to the standard transfer requirements, the franchisor will want to receive notice of any such transfer.

Death or Incapacity

When the franchisee is a natural person, the franchisee's death would be an involuntary, immediate and unplanned transfer, which may technically allow the franchisor to terminate the franchise agreement. The franchise agreement should specifically regulate the procedures for transferring, continuing, or terminating the franchise in the event of the franchisee's death during the franchise term in a manner that does not result in such a forfeiture of the franchisee's investment.

The franchisor will typically require the heirs to sell the franchise either back to the franchisor or to a qualified third party. The franchisor may also allow the heirs or surviving spouse to continue the operations of the franchise, provided that they meet certain personal and financial qualifications.

Regardless of the ultimate disposition of the franchise, there will be an interim period during which either the franchisor or the heirs or personal representatives of the franchisee's estate will have to assume responsibility for operating the business. These interim procedures should be spelled out clearly in the franchise agreement.

A few states, most notably California and Indiana, have attempted to provide by statute for the orderly transfer of a franchise following the death of a franchisee. The California franchise relationship law provides that after a "reasonable" period of time after a franchisee's death, the failure of the heirs to qualify or locate a suitable transferee will operate to terminate the franchise. California Business & Professions Code, §20027(a). The Indiana Deceptive Franchise Practices Act also provides that the heirs of a deceased franchisee must be allowed to participate in the ownership of the franchise for a reasonable time, conditioned upon their maintenance of certain standards and obligations. Indiana Code, Title 23, Art. 2, Ch. 2.7, §2(3).

Divorce

The franchisor may also want to make special provisions for the smooth transfer of the franchise in the event of the franchisee's divorce -- particularly if only one of the spouses had been operating the franchise and executed the franchise agreement. The absence of such a provision can lead to an unintended result. One California court, for example, awarded a franchise, previously operated solely by the husband, to the wife. The wife had no business experience. The franchisor had agreed to accept the wife as the new franchisee if the court awarded her the franchise. The court specifically held that the wife's lack of business experience would not bar her award of the franchise. *Kozen v. Kozen*, 185 Cal. App. 3d 1258, 230 Cal. Rptr. 304, Bus. Franchise Guide (CCH) ¶8708 (1986).

Transfers in Bankruptcy or by Operation of Law

Even if the franchise agreement requires the prior approval of the franchisor to any

assignment or other transfer of the franchise, and provides for the automatic termination of the franchise if such approval is not obtained, Section 365(f)(3) of the Bankruptcy Code specifically provides that the franchise agreement may *not* be terminated upon assignment or assumption by the trustee. 11 U.S.C. §365(f)(3). In other words, the trustee has the power to override such restrictions in the franchise agreement so long as the conditions of Section 365(f)(2) are met and the agreement is not non-delegable under applicable state law (as under certain dealer laws and personal service contracts). *See, e.g., In re Old South Coors*, 27 B.R. 923, Bus. Franchise Guide (CCH) ¶7955 (Bankr. N.D. Miss. 1983).

Transferee Standards; Terms of the Proposed Transfer

Franchisors commonly police the entry of transferees into their systems and limit such transferees to those meeting reasonable financial, professional and personal qualifications and standards. A few franchise agreements provide only that the franchisor's approval of a proposed transfer will not be unreasonably withheld. Most agreements, however, spell out in detail the criteria to be considered in determining the acceptability of the proposed transferees.

These criteria generally fall into two categories: (1) the standards imposed on the proposed transferee, and (2) the terms of the proposed transfer. Under the first category, the franchisor may consider the transferee's character, business experience, financial stability and resources, and whether the transferee is affiliated in any way with a competing business. The second category may include such matters as the right of the franchisor to require prior training of the proposed transferee, the imposition of a reasonable transfer fee, the reasonableness of the purchase price of the franchise, execution by the transferee of the franchisor's current form of franchise agreement and the execution of a release of claims against the franchisor.

Courts have upheld several of the above criteria as constituting valid reasons for withholding consent to the proposed transfer of a franchisee's interest in a franchise agreement. The franchisor's right to withhold its consent to an assignment based on the transferee's lack of business experience and poor capitalization was upheld in *Town and Country Ford, Inc. v. Ford Motor Co.*, Bus. Fran. Guide (CCH) ¶8660 (N.D. Ga. 1985). *aff'd*, 800 F.2d 266 (llth Cir. 1986), and in *Portaluppi v. Shell Oil Co.*, 869 F.2d 245 (4th Cir. 1989).

In *In re Pioneer Ford Sales, Inc.*, 729 F.2d 27 (1st Cir. 1984), the court found that the franchisor's disapproval of a bankrupt franchisee's assignment was reasonable under the applicable state motor vehicle dealer law, since the proposed assignee lacked the required capital, had a poor sales record with its other franchise, and could not adequately assure future performance of the franchise agreement. A franchisor's refusal to consent to the transfer of a franchise to a competitor has also been upheld. *See Rickel v. Schwinn Bicycle Co.*, 144 Cal. App. 3d 648, 192 Cal. Rptr. 732 (1983); *Sally Beauty Co., Inc. v. Nexxus Products Co., Inc.*, 578 F. Supp. 178 (N.D. Ill. 1986); *Berliner Foods Corp. v. Pillsbury Co.* , 633 F. Supp. 557, Bus. Franchise Guide (CCH) ¶8566 (D. Md. 1986).

In *Kestenbaum v. Falstaff Brewing Corp*., 514 F.2d 690 (5th Cir. 1975), *cert. denied*, 424 U.S. 943 (1976), and *Walner v. Baskin Robbins Ice Cream Co.*, 514 F. Supp. 1029 (N.D. Tex. 1981), the courts upheld a franchisor's right to restrict the sale price of a franchise to a reasonable value in order to protect the transferee's financial viability.

In virtually all cases, franchisors will want to condition approval of transfers on the absence of a default by the franchisee under the franchise agreement and any related agreements, such as the lease agreement for the premises on which the franchised business is located. Additionally, prospective transferees should be required to participate in a training program given either by the franchisor (perhaps for a fee) or by the franchisee with oversight by the franchisor -- preferably before the closing of the transfer.

Franchisors may also want to include payment of a transfer fee as a condition of their consent to the transfer. Such a fee will be upheld as long as it is reasonably related to the costs of the transfer. Finally, a franchisor may want to condition the transfer on the proposed transferee's agreement to update and modernize the business to current franchise standards, and on the execution of a new franchise agreement in the form of those then being used for new franchisees. This list is not exhaustive, and other conditions to transfer can be added depending on the nature of the franchise and the type of transfer involved.

Statutory Restrictions Regarding Transfer

State law may limit transfer of the franchise, just as state law limits termination and nonrenewal. States that regulate transfers are concerned that restrictions on transfer may be so severe that they greatly reduce the value of the franchise to the franchisee.

These state laws include the following: Arkansas (notification procedure regarding prospective transferees and restrictions on types of transfers which cannot be prohibited by franchisor provided that certain qualifications regarding character, financial ability and business experience are met); California (procedural requirements regarding transfer to heirs of deceased franchisee); District of Columbia (notification procedure regarding prospective transferees with certain time limitations, requirement that transferee agree to comply with all franchise requirements, and prohibition of franchisor disapprovals when proposed transferee meets reasonable qualifications); Hawaii (good cause requirement for disapproval of transfer and certain notification procedures established); Iowa (transfer allowed provided the transferee satisfies the reasonable current qualifications for new franchisees); Indiana (no disapproval of deceased franchisees heirs so long as maintain franchise standards and obligations); Michigan (good cause requirement for disapproval of transfer); Minnesota (no unreasonable withholding of consent to transfer); Nebraska (notification procedure regarding approval of prospective transferees; no restriction on transfers to certain transferees, e.g., heirs, employees, so long as basic financial requirements met); New Jersey (*see* Nebraska requirements); and Washington (no automatic termination of agreement upon death of franchisee; certain restrictions on franchisor's ability to disapprove a transfer; imposition of reasonable transfer fees; and any requirement that franchisee

execute release regarding claim under state Franchise Investment Protection Act void).

Franchisor's Right of First Refusal

An effective method by which a franchisor may exert some control over the transfer process is by including in the franchise agreement a provision guaranteeing the franchisor's right to match any offer made by a third party to the franchisee for the sale of its franchise. Prospective franchisees may object to this type of provision, because a right of first refusal can make it difficult for the franchisee to find a serious purchaser. The prospective transferee may be unwilling to purchase a franchise that would require a franchisee to go to the trouble of obtaining a bona fide third party offer for the franchisee's business, only to see its efforts defeated by the franchisor. Nevertheless, such a provision is not uncommon in franchise agreements.

A right of first refusal clause should clearly define the elements that trigger the franchisor's right of first refusal. This is commonly the receipt by the franchisee of a bona fide offer in writing from a third party. The clause should clearly set forth the timing and content of the notice to the franchisor, the mechanism for the franchisor's exercise of the right and the consequences of the franchisor's failure to exercise the right. Several state statutes directly address the timing issue, and require that the franchisor respond to the franchisee's offer within a set time period – often 60 days – failing which the transfer to the third party will be deemed to be approved and the franchisor will be deemed to have waived its right of first refusal. *See, e.g*., Ark. Code Anno., §4-72-205 (1987); Neb. Rev. Stat., §87.405; and N.J. Rev. Stat. §56:10-6. The reason for such statutory concern with the timing of the franchisor's response is the very real possibility that an excessive delay on the part of the franchisor in exercising its right of first refusal will result in the franchisee's loss of the third party offer.

Disclosure Issues

The disclosure obligations under federal and state laws generally do not extend to the resale of a franchise by a franchisee. *See, e.g*., Cal. Fran. Inv. Law, §31102, Bus. Franchise Guide (CCH) ¶3050.26, and related statutes in Maryland, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Washington and Wisconsin.

However, this private resale exemption will be lost if the franchisor actively participates in the sale or transfer. While the mere disapproval or approval of a transfer and the charge of a transfer fee will generally not trigger disclosure obligations, the franchisor's active assistance to a franchisee in selling its franchise may bring the franchisor within the scope of the disclosure requirements, including the rules relating to the first face-to-face meeting, the 10-day waiting period for closing, and so forth. Such active assistance by the franchisor may include finding the transferee or making a sales pitch to the proposed transferee. Charging a finder's fee indicates that the franchisor is playing an active role. Simply requiring the transferee to execute the then-current franchise agreement may also trigger the disclosure requirements. The franchisor must also disclose if the original franchise agreement has been materially changed. If such disclosure is not made, the franchisor will be in violation of the applicable disclosure regulations and may

be held liable for any misrepresentations made to the proposed transferee during the course of the sale negotiations. *See Boca Mara Properties, Inc. v. International Dairy Queen, Inc*., 732 F.2d 1550 Bus. Franchise Guide (CCH) ¶8173 (llth Cir. 1984), and *Interstate Automatic Transmission Co. v. Harvey*, Bus. Franchise Guide (CCH) ¶8174 (Mich. App. 1984).

Even if the franchisor has not actively participated in the sale or transfer, it still might be advisable for the franchisor to comply with the disclosure requirements. Otherwise, the only information received by the proposed transferee regarding the operation of the franchise comes from the transferring franchisee, who may not be entirely forthcoming, and a lawsuit could easily develop as a result of misrepresentations by the transferring franchisee, in which the franchisor might also be sued. The franchisor may therefore want to make disclosure one of the conditions of its consent to the transfer.

Transfer by the Franchisor

While transfer of the franchise agreement by the franchisee is regulated by some states, transfers by the franchisor are not restricted in most states. Accordingly, many franchise agreements specifically give the franchisor the unlimited right to assign the agreement upon notice to the franchisee. This allows the franchisor to sell the assets of its business and to transfer all of the franchise agreements without getting approval from each of the franchisees.

Is such a clause necessary? It is likely that a court would uphold the right of the franchisor to transfer the agreement in the absence of a clause specifically allowing the franchisor to do so. *See Marc's Big Boy Corp. v. Marriott Corp*., Bus. Franchise Guide (CCH) ¶9100 at 18,828 (E.D. Wis. 1988); *O'Neal v. Burger Chef Systems, Inc.*, 860 F.2d 1341, Bus. Franchise Guide (CCH) ¶9251 (6th Cir. 1988). It would be difficult for the franchisee to argue, for example, that the agreement was one for personal services. *See Berliner Foods Corp. v. Pillsbury Co.*, 633 F. Supp. 557, Bus. Franchise Guide (CCH) ¶8566 (D. Md. 1986). This kind of clause is also helpful because it informs the franchisee of the franchisor's rights.

Is there any reason the franchisor might want to consider a contractual provision limiting its right to transfer? Yes; a properly drafted clause would make the franchise more appealing to franchisees and would not unduly burden the franchisor. The franchisee may have some concern about the acquisition of the franchisor by another company that might have a different view of the business direction of the system.

The Iowa franchise law provides, in Section 523H.5., subsection 7, that a franchisor may transfer its interest in a franchise *only* if it makes "reasonable provision for the performance of the franchisor's obligations under the franchise agreement by the transferee". Adequate notice of the proposed transfer is also required.

TERMINATION

Termination by the Franchisor

While the franchisee expects a fixed term in exchange for the initial fee and investment, the franchisor must have the right to cut this fixed term short if the franchisee fails to meet system standards. This protects the franchisor's trademark and maintains the value of the entire system. The franchisor may also want to terminate the agreement if the franchisee is not adequately selling or promoting the products or services of the franchise in its territory.

The franchise relationship laws of several states reflect this basic business concept, limiting the grounds for termination by the franchisor. At a minimum, the franchisor must have good cause for termination. Good cause can mean any material breach of the agreement, such as damaging the franchisor's reputation, unauthorized use of the franchisor's trademark, selling competing products, failing to maintain system standards, failure to meet sales requirements, failure to pay the required royalties, underreporting sales or transferring the franchise without the franchisor's consent.

The franchise relationship laws require that the franchisor give prior written notice of termination. The minimum number of days' notice varies from state to state and from cause to cause. Most state laws allow for immediate termination based on abandonment of the unit or for fraud. Some state franchise laws also require that the termination notice include all the reasons for termination and an opportunity to cure. Case law may expand on these requirements. For example, a failure to meet minimum sales requirements might require one year's notice or more. See *Wadena Implement Co. v. Deere & Co., Inc.,* Bus. Franchise Guide (CCH) ¶9946 (Minn. 1992) (holding that where market share performance is measured annually, a dealer is entitled to a full year's time in which to comply). On the other hand, the franchisor will want to be able to terminate immediately where there is a threat to health or safety that is not cured as soon as the franchisee is warned. Similarly, when the franchisee damages the franchisor's goodwill or is on the brink of entering bankruptcy proceedings, the franchisor will want to be able to terminate quickly.

Market Withdrawal

Market withdrawal by the franchisor might be a valid basis for termination by the franchisor in dealership arrangements that are of indefinite term, just as market withdrawal might be a basis for nonrenewal, as discussed above. However, it would not appear to be fair to allow the franchisor to terminate a fixed term agreement on the basis of a business decision to withdraw from the market where the franchisee has made a significant investment in the business, unless the franchisor compensates the franchisee in some manner. Because of the difficulties in determining such compensation and because of the potential negative impact on franchise sales of even raising the possibility of termination without fault of the franchisee, it would be very unusual for a franchise agreement to contain this type of provision.

Alternatives to Termination; Repurchase

While it is important for the franchisor to have the right to terminate in appropriate cases, a disputed termination is so costly that franchisors often prefer to seek less drastic remedies. One approach would be to assist the franchisee to sell his or her business and transfer the franchise to a successor franchisee.

The franchisor might also want to reserve the right in the agreement to take certain steps upon breach by the franchisee that would not constitute termination but which might bring the franchisee to the table to discuss a resolution of the dispute. For example, if the franchisee falls behind in royalty payments, the franchisor might reserve the right, in addition to termination, to suspend all services to the franchisee and the sale of products and supplies until the franchisee is in compliance. In an extreme case, the franchisor may want the right to take over the management of the franchise, at the franchisee's expense, until the default has been remedied.

Another alternative to termination would be for the franchisor to buy back the franchise. Just as some shareholder and joint venture agreements give shareholders or partners the right to purchase the interest of other shareholders or partners at an option price, a franchise agreement may include an option for the franchisor to purchase the franchised business. Options differ from rights of first refusal primarily because options require a valuation mechanism, while the value in a right of first refusal is determined by the third party offer.

Options are difficult to draft because of the valuation problem. The purchase price may be based on book value, a multiple of revenues or profits, or an appraised value. Where the option arises upon termination without cause by the franchisee or with cause by the franchisor, the purchase price may be simply the cost or book value of the franchisee's inventory and equipment. Like a right of first refusal, an option assures that the outlet will remain in the franchise system if the franchisor finds this to be desirable. With the purchase of the business, it is also more likely that a covenant not to compete will be effective.

Some state laws require repurchase upon termination, although these laws vary widely from state to state. The agreement should consider what happens to the franchisee's equipment, advertising materials and supplies, inventory and furnishings in the event of termination. The franchisor should determine what makes business sense, and reflect this in the agreement. Should the franchisor offer to repurchase in all cases, or only where there is no good cause for termination? Should repurchase be required in the case of both termination and nonrenewal? What will be repurchased? What will be the purchase price?

Real Estate

If control of location is important to the franchisor, the best protection from the franchisor's point of view is for the franchisor to own the location and lease it to the franchisee.

The lease can provide for termination in the event of the termination of the franchise agreement. The risks associated with being the prime tenant of the property from either an environmental or financial liability standpoint may dissuade a franchisor from being a party to the lease.

An alternative method of controlling real estate for franchisors without assuming the liabilities of a prime tenant is for the franchisor to require a conditional assignment of the lease. Under the conditional assignment, the franchisee is the tenant. The lease is conditionally assigned to the franchisor, with the assignment taking effect only in the event of the termination or expiration of the franchise agreement. Thus, the franchisor controls the property at the critical time, upon termination of the franchise agreement.

If the lease is in the franchisee's name and the property is not owned by the franchisor, the franchise agreement might be terminable upon the termination of the lease and perhaps the failure of the franchisee to enter into a lease for a new property acceptable to the franchisor.

Where the franchisee owns the premises at which the franchised business is conducted, the franchisor may want to include in any repurchase provision the right to purchase the premises or lease the premises at commercially reasonable terms. The value might be determined by an independent appraiser. None of these provisions will be easy to enforce in the event that the franchisee disputes the validity of the termination. Some state courts, however, are more familiar with and comfortable with enforcing real estate related remedies as opposed to remedies permitted under the franchise agreement.

Post-Term Noncompetition

Most franchise agreements contain a clause prohibiting the franchisee from engaging in a similar or competing business for a specific period of time within a designated geographic area. Reasonable post-term covenants not to compete are enforceable in most states, *Floor Coverings International, Ltd. v. Lott*, Bus. Franchise Guide (CCH) ¶11,776 (W.D. Ok 2000) (two year noncompetition restriction in adjoining counties was reasonable); *DAR & Associates, Inc. v. Uniforce Services, Inc.*, 37 F. Supp. 2d 192, Bus. Franchise Guide (CCH) ¶11,580 (E.D. NY 1999) (one year 50 mile noncompetition provision was enforceable); *Sparks Tune-Up Centers v. White*, Bus. Franchise Guide (CCH) ¶9410 (E.D. Pa. 1989) (10 mile one year provision was reasonable and enforceable). Certain state statutes prohibit or restrict the enforcement of post-term noncompetition agreements. A post-term covenant not to compete is likely to be enforceable when the franchisor purchases the business from the franchisee, whether under a right of first refusal, a purchase option or otherwise.

May a franchisee avoid the effects of a seemingly enforceable provision by simply letting a spouse or other relative take over the competing business? Several courts have held that a noncompetition covenant in a franchise agreement may be used to enjoin a spouse, other relative or insider from operating a former franchise location, even though the party was not a signatory to the contract. *KFC v. Duncan*, Bus. Franchise Guide (CCH) ¶8924 (W.D.Ky. 1987) (prohibiting

spouse from operating former franchised locations); *McCart v. H&R Block, Inc.*, 470 N.E.2d 756 (Ind. App. 1984) (husband of former franchisee prohibited from operating competing tax business even though he had not signed franchise agreement).

Courts may undertake a balancing approach in considering the enforceability of the non-compete provision, completely redraft the provision to more reasonable terms, or refuse to enforce the provision at all in the event it is unreasonable. A balanced non-compete provision is beneficial to both parties, the franchisee may have a reduced restricted geographic area or time limitation and the franchisor may get a provision that is enforceable.

In all cases, a franchisor should focus on the confidentiality provisions of the agreement and on trade secrecy law to protect its interests after termination. Such provisions are enforceable without limitation in time or geographic scope.

Termination by the Franchisee

Very few franchise agreements provide that the franchisee can terminate the agreement upon the material breach by the franchisor. It is difficult to see, however, how such a clause could hurt the franchisor. The franchisor might also consider requiring notice of such breach and an opportunity to cure.

What about termination by the franchisee without cause? As noted above, short term agreements are generally more advantageous to franchisors than franchisees because they allow the franchisor to replace an unacceptable franchisee upon the expiration of the agreement. A long, fixed term gives the franchisee assurance that the business will have a reasonable life and justify the franchisee's investment. Where the business is not profitable, however, the franchisee may want to terminate before the expiration of the fixed term in order to limit his or her losses. From the franchisor's point of view, it may make no sense to hold the franchisee liable for damages for abandonment when the initial fee was based on a longer term and the franchisor is given a reasonable length of time to find a new franchisee for the location. It may be to the advantage of both parties, then, to include in the agreement a clause allowing the franchisee to terminate the agreement without cause at any time on reasonable notice, such as six months.

Just as the franchisee will want to be able to amortize his or her investment, however, the franchisor may also want to amortize its investment in the new franchise. Any number of variations on this theme are possible which allow some assurance to the franchisor. One simple approach would be to provide in the agreement that the franchisee has the option to terminate without cause, but only after a minimum period, such as five years. This would provide the franchisor with at least five years to amortize its investment.

DISPUTE RESOLUTION

Provisions in the franchise agreement regarding governing law and dispute resolution are some of the most hotly litigated and negotiated in franchising. The reason for such attention is that these provisions often significantly effect the outcome of franchise litigation, even before it is filed. Franchisees may unknowingly waive rights under state law by agreeing to certain provisions. Both franchisee and franchisor counsel should carefully review and negotiate such provisions, which may be buried as seeming boiler plate in the franchise agreement. Choice of law, choice of forum, arbitration, and jury waiver provisions are among the most important.

Choice of Law

Franchisors have a legitimate interest in specifying a choice of law so that the franchise agreement used nationwide is uniformly construed in state courts. Most often, the franchise agreement will provide that the law of the franchisor's state will govern all claims arising under or related to the franchise agreement. The provision must be drafted broadly enough to include those claims that arise because of the franchise relationship, not just those that relate to the franchise agreement. Provided that the state law chosen bears some reasonable relationship to the transaction, choice of law provisions are generally enforced. *Learning Express, Inc. v. Ray-Matt Enterprises, Inc.*, 74 F. Supp.2d 79, Bus. Franchise Guide (CCH), ¶11,737 (D. Mass. 1999). Agreeing to a choice of law applying the franchisor's state law may act as a waiver by the franchisee of protections under the franchisee's state franchise law. *Mid Florida Yogurt v. TCBY Enterprises*, 158 F.3d 588, Bus. Franchise Guide (CCH), ¶11,543 (11th Cir. 1998) (by specifying Arkansas law, Florida franchisee waiver claims under the Florida Franchise Act).

Choice of law provisions may not be applied where their application might violate the public policy of the franchisee's home state. For example, in *Cottman Transmission Systems, Inc. v. Melody*, 869 F. Supp. 1180, Bus. Franchise Guide (CCH) ¶10,558 (E.D. Pa. 1994) the court applied Pennsylvania law to a conflict between a California franchisee and a Pennsylvania franchisor. The court would not allow the franchisee to bring claims under the California Franchise Investment Law, noting that the parties had chosen Pennsylvania law and the franchisee could receive similar protection under Pennsylvania common law. The court refused, however, to grant full relief to the franchisor, noting that enforcement of a non-compete provision violated California statute and public policy.

Franchisees should be careful not to waive important rights under their own law by agreeing to a choice of law provision. From the franchisor standpoint, designating a state that has no franchise act or franchise relationship law is advantageous.

Forum Selection

Forum selection provisions, like choice of law provisions, promote a uniform interpretation of the franchise agreement. A second and equally compelling reason that franchisors

generally like forum selection clauses is that they can place the franchisee at a considerable financial disadvantage if required to litigate in a foreign jurisdiction. The U.S. Supreme Court has held that even a forum selection provision designating a remote forum should be enforced absent a strong showing that it should be set aside. *Carnival Cruise Lines, Inc. v. Shute*, 499 U.S. 585, 592 (1991). In the franchise context the analysis is almost always determined based in the specific facts and circumstances of the case. Were other provisions negotiated? Is the franchisee a sophisticated business person? Was the provision conspicuous? If the answers to these questions are "yes," the clause will generally be enforceable. *DFO, Inc. v. Northeast Inn of Meridian, Inc.,* Bus. Franchise Guide (CCH) ¶11,552 (C.D. Ca. 1998).

In recent years, forum selection provisions have come under increasing attack from state legislatures and courts. For example, California has passed a state statute invalidating provisions restricting venue outside California if the franchise business operates in California. California Business and Professions Code 20040.5. See also *815 Ill. C. Stat. 705/4* (Illinois statute prohibiting designating forums outside of Illinois); Michigan Franchise Investment Law, Chapter 445, Section 445.1527(f). In *Swendseid v.GNC Franchising, Inc.* Bus. Franchise Guide (CCH) ¶11.720 (C.D. Ca. 1999), the court noted that a forum selection provision was distinguishable from a choice of law provision. The court refused to allow the transfer of a matter based on a forum selection provision noting that such a transfer violated a strong public policy of California as expressed by statute. The court distinguished the *Melody* case, *above,* as one involving choice of law, against which there is no prohibition in California.

Other recent cases have further called into question the validity of forum selection clauses, even where there is no express statutory prohibition. *See Pepe v. GNC Franchising, Inc., 2000 WL 233287 (Conn. Super. Feb. 15, 2000)* (forum selection provision void as to claims under state franchise statute as it acted to void right to bring claims in Connecticut Court); *Tri State Foundation Repair & Waterproofing, Inc. v. Permacrete Systems, Inc.,* 2000 WL 245824 (W.D. Mo. March 1, 2000) (court refused to dismiss action brought by franchisee even though the agreement required that any action be brought in a foreign jurisdiction).

Forum selection provisions will come under increasing attack as more states pass protective franchise statutes. Choice of law and arbitration provisions which may accomplish the same objectives as forum selection clauses appear to have a greater chance of being enforced in coming years.

Arbitration

Many franchise agreements include mandatory arbitration provisions, which seek to accomplish the same goals as forum selection and choice of law provisions. Arbitration provisions often designate the forum for the arbitration, the arbitration rules and the types of damages that may be awarded. Again, the franchisor's objective is to reduce the risk of a large award, secure a friendly forum and control the cost of litigation. An added benefit is that arbitration provisions reduce the risk of class actions by groups of franchisees.

From the franchisee's point of view, an arbitration provision may appealing. The franchisee will almost always have claims heard more quickly in an arbitration, the matter is conducted without extensive, costly discovery, and arbitrators will often make compromise verdicts. While the franchisee will forego the opportunity of a large damage award, there is a much greater chance the franchisee will receive a hearing on its claims, as there is no summary proceeding in arbitration.

As with a choice of law provision, the arbitration clause should be drafted broadly enough to encompass all disputes that may arise from the franchise relationship. The Federal Arbitration Act (FAA) 9 U.S.C. § 1, *et seq.* provides that arbitration provisions are valid, irrevocable and enforceable, and this federal law preempts state statutes that seek to limit arbitration. While a court may not impose arbitration upon a party who has not agreed to arbitrate, federal policy favors arbitration and any doubts as to arbitrability should be decided in favor of arbitration. *Versailles Enterprises v. Schlotzsky's Inc.,* Bus. Franchise Guide ¶11,788 (E.D.N.Y. 2000). Ordinarily an arbitration clause will be enforced unless obtained by fraud or the contract is unconscionable.

By designating arbitration in a foreign forum, might a franchisor in effect enforce a forum selection provision in a state where such a provision would be invalid? The answer to this question has been mixed. In *Laxmi Investments, LLC v. Golf USA*, 193 F.2d 1095, Bus. Franchise Guide (CCH) ¶ 11,706 (9th Cir. 1999), the court considered whether a California franchisee could be forced to arbitrate claims in Oklahoma, even though California has a law prohibiting forum selection provisions. The court did not decide the issue of preemption, relying instead on the fact that the Uniform Franchise Offering Circular ("UFOC") given to the plaintiff stated (as required by California law) that forum selection provisions were not valid under California law. Based on that statement in the UFOC the court reasoned that the franchisee could not have had a meeting of the minds with regard to the forum even though the clause was contained in his franchise agreement. *See also Alphagraphics Franchising, Inc. v. Whaler Graphics, Inc.*, 840 F. Supp. 708 (D. Ariz. 1993).

The question of requiring a specific forum for arbitration is really left open by the *Laxmi Investments* case. Had the franchisor put a statement in the UFOC that it would seek to enforce a specific forum for the arbitration would the decision have been different? As with other provisions that require knowing and intelligent waivers, the franchisor should draw attention to this provision at the time of executing the franchise agreement to increase the chance of enforceability.

Jury Waiver

If the franchise agreement does not require mandatory arbitration, there will normally be a jury waiver provision requiring the franchisee to waive right to a jury trial. Franchisors typically insist on such provisions to avoid large damage awards that sympathetic juries might

impose. Non jury trials are less costly and proceed to trial more quickly than jury trials. Of course this may be one reason that a franchisee might not object to a jury waiver provision, particularly a franchisee of limited means.

Courts will generally enforce knowing and voluntary waivers of a jury trial. *See Cottman Transmission Systems, Inc. v. Melody,* Bus. Franchise Guide (CCH) ¶10,662 (E.D. Pa. 1994); *Bonfield v. AAMCO Transmissions*, 717 F. Supp. 589 (N.D. Ill. 1989). The court will examine four factors to determine whether the waiver was knowing and voluntary: (1) gross disparity in bargaining power; (2) the business and personal experience of the party waiving the jury trial; (3) the negotiability of the contract; and (4) the conspicuousness of the waiver clause. The burden of proof is generally on the party seeking to enforce the waiver. *See Cottman Transmission Systems, Inc. v. Melody,* Bus. Franchise Guide (CCH) ¶10,662 (E.D. Pa. 1994). *But see*, *KMC Co. v. Irving*, 757 F.2d 752, 755 (6th Cir. 1985) (burden is on party seeking to invalidate jury waiver provision).

A franchisor might want to specifically bring the jury waiver provision to the attention of a franchisee before signing the franchise agreement. This assures that the franchisee is making a knowing and intelligent waiver and provides a greater chance of enforceability in the event the franchisee later challenges the provision.

CONCLUSION

Franchise agreements, like franchises, come in endless varieties. From the drafter's point of view, there is ample room for creativity and personal style.

The drafter of a franchise agreement, or any business agreement for that matter, must begin with a thorough understanding of the business requirements of the client. After that, a review of the agreements of competitive franchisors, consideration of the various approaches suggested in this paper and the requirements of the franchise relationship laws will help in the preparation of a first draft. It goes without saying that a clear and logical writing style, and lots of work rereading and revising the draft agreement will go a long way toward the creation of an agreement in which the drafter and client can take pride.

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- *International Franchise Agreements* (New York State Bar Association Program on International Agreements, 1998)
- *The Inadvertent CyberFranchisor,* CYBERSPACE LAWYER (April 1998)
- *Negotiating a Computer Software License,* THE FRANCHISE UPDATE REPORT (April 1998)
- *Franchisors as Web Developers*, Forum Newsletter (The Franchise Lawyer, Spring 1997)
- *Franchise Relationship Laws: A Minefield for Franchisors*, 45 BUS. LAW. 289 (1989), reprinted in the American Bar Association's BUILDING FRANCHISE RELATIONSHIPS (1996)
- *Choice of Law in Franchise Relationships: Staying Within Bounds*, 14 FRANCHISE L. J. 89 (Spring 1995)
- *Avoiding the Long Arm of the Law in International Franchising,* (ABA Forum on Franchising, October 1995) (co-authored with Andrew Loewinger)
- *The Content of International Franchise Agreements*, Fundamentals of International Franchising Program, ABA Annual Meeting (August 1994)
- *Laying the Keel: Drafting Effective Franchise Agreements* (ABA Forum on Franchising, October 1992) (co-authored with Kim A. Lambert)
- Ways to Avoid Being a Franchise, FRANCHISE L.J. (Fall 1992)

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