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## NEGOTIATING A COMPUTER SOFTWARE LICENSE

by Thomas M. Pitegoff

Franchisors are accustomed to negotiating their franchise agreements, even though franchisors commonly tell their prospective franchisees that the franchise agreement is not negotiable. A franchisor acquiring an important software package should not suddenly change gears and accept a software agreement without negotiating it, just because the franchisor is now in the role of a licensee and because the licensor may be a major software company. Instead, the franchisor should take a careful look at the agreement, discuss it with legal counsel, and then propose changes that make business and legal sense.

Franchise companies and others sometimes hire outside suppliers to develop proprietary software, or independent

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## MANAGING BUSINESS IN THE AGE OF LITIGATION: THE SECRET IS IN THE PREPARATION

by Joyce Mazero

Facing the daily challenges of business fortune and misfortune is difficult, but facing the time and money draining mandates of litigation can literally “kill a business.” This was a sentiment heard to be expressed by observers of the Meineke debacle as well as some Meineke franchisees and other insiders. Does this type of litigation serve the purpose of compensating “wronged” franchisees if ultimately the franchise system is harmed in the long term because of the monetary burden of litigation? It is a timeless issue.

Anticipating and reducing the likelihood of this type of debilitating as well as less intrusive litigation among franchisors and franchisees was on the minds of attendees at the IFA Annual Convention held in March in Las Vegas

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## SBA DELIVERS FRANCHISE REGISTRY FOR FRANCHISE LOANS

by Neil Simon

Following a turbulent conception (in which this attorney played a minor, non-biological role) and hard labor with political complications, the SBA delivered its much discussed Franchise Registry on February 20, 1988 by awarding a contract to Washington-based FRANDATA Corporation to create and maintain the new system. Though born in controversy, the new arrival promises to make it easier for franchisees to obtain SBA guaranteed loans by streamlining the approval process and eliminating inconsistent decisions among the SBA's regional offices. According to FRANDATA president Jeff Kolton, the new program will be operational by June. In 1996, the SBA approved 3,708 franchise loans amounting to more than \$978.50 million.

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## TECHNOLOGY

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contractors to assist in their in-house software development. These types of agreements should definitely be put in writing by legal counsel, if for no other reason than to ensure that the company owns the rights it intends to own. At the other end of the spectrum are off-the-shelf packages, often referred to as "shrinkwrap," which are seldom negotiated.

A third type of software agreement, which is discussed in this article, is a license that is more expensive than shrinkwrap. Initial fees can run in the tens or even hundreds of thousands of dollars. This type of software may require assistance from the supplier both for its installation and support. Examples include network operating systems from Novell or Microsoft, database and financial programs from Oracle or SAP, and many others. The same considerations come into play when a company purchases a package that includes both hardware and software, whether it be routers from Cisco or Cabletron, servers from Compaq or IBM, or the like.

Software purchases, like franchise purchases, are effected by means of license agreements. Although most franchisors are not in the computer business, the concept of a license is second nature to franchisors. Because of the fundamental differences in the subject matter of the two types of agreements, though, the considerations involved in software licensing are very different from those in franchising. Moreover, a franchisor accustomed to negotiating license agreements from the point of view of the licensor must look at a software license agreement anew from the perspective of a licensee.

### Scope of Use

The scope of use clause is as important in a software license agreement as it is in a franchise agreement. Licensors draft restrictive licenses for the simple reason that they want to maximize their revenues. Licensees generally seek a broad scope of use with maximum flexibility.

The initial fee in a software license is often based on the size of the network or the number of users, with lower prices per-user or per-workstation when the overall size of the network is larger. Peoplesoft takes a different approach, basing its pricing for human resources packages on the number of employees the software tracks rather than the number of users. Whatever the approach, there is almost always room for negotiation. The franchisor/licensee may be able to get the best price by negotiating one agreement for its entire company, and

possibly one that includes its franchisees. A software licensee is generally an end-user, unlike a franchisee who distributes the franchisor's products or services. Nevertheless, a franchisor/licensee does have a captive customer base of franchisees.

Other issues relating to the scope of the license are also important. Does the agreement permit the licensee to make only one backup copy or any number of copies for purposes of testing, backup and disaster recovery? Does it permit the licensee to use the software at its other locations? Does it allow for an increase in the number of users?

### Warranties

The licensor's warranties are also extremely important. These should include a warranty against infringement. A licensee needs to know that the licensor has a right to grant the license and that the licensee's use of the software will not infringe on the rights of a third party. A licensee will also want the agreement to refer to written specifications for the software and specific functional characteristics. The licensor should expressly warrant that the software will meet those specifications and will function as promised.

Software licensees should always ask for a "year 2000" warranty. In other words, the licensor should warrant that the software will function properly with all date data, whether for years in the same century or in different centuries. The software should yield correct results in comparisons and sorting of date fields and should not return an error message due to date-related processing. The agreement should also confirm that no windowing techniques were used. When a windowing technique is used, the software may read "98" as "1998" and "02" as "2002" with an arbitrary line drawn at a specific date, so that the software may read "40" as "1940," while it might read "39" as "2039." A windowing technique simply delays the Year 2000 problem.

If the licensor is unwilling or unable to make a Year 2000 warranty, the licensor should indicate the extent to which it is willing to provide a Year 2000 warranty. Which of the licensor's products have been tested? Which are compliant? What tests has the licensor done? If a windowing technique has been used, will it afford the licensee adequate protection?

### Other Licensing Issues

When is the software to be delivered and installed? Will personnel of the licensor come on site for a specified number of days to install the software and train the licensee's employees in its use? Is the entire initial fee

due in advance? In many cases, the licensee will want to pay a portion of the initial fee in advance and to leave a substantial portion of the initial fee to be due after installation and testing.

If the licensee is involved in a corporate merger, reorganization or sale, does the agreement permit the licensee to assign the license to the successor company without the licensor's approval? If not, the merger, reorganization or sale may be more expensive than anticipated.

Software licensors typically limit their liability, often to the amounts of money paid by the licensee to the licensor. The licensee should consider whether this limit is too restrictive. If so, should an exception be made for failures of warranties, such as the Year 2000 warranty or the warranty against infringement? Should an exception be made for personal injuries and property damage caused by licensor personnel when working on the licensee's premises? Should such losses be limited to the extent of the licensor's insurance?

With software that is essential to a licensee's business and that requires frequent updates and modifications, the licensee might consider a source code escrow arrangement. In this type of arrangement, a company that is in the business of holding source code in escrow will enter into an agreement with the licensor and the licensee and will hold a copy of the source code, supplied by the licensor. If the licensor defaults or goes bankrupt, the escrow company will deliver a copy of the source code to the licensee. While these arrangements entail a small fee, it is often worth the price for the sake of peace of mind.

Some software agreements have termination clauses. Unlike franchise agreements, however, termination clauses are not universal and are not essential in software license agreements. Software becomes obsolete so quickly that some licensors grant perpetual licenses in exchange for the initial fee. Instead of terminating the license altogether in the event of a material breach by the licensee, the licensor has the leverage of terminating the maintenance agreement, thereby cutting off the licensee's access to the licensor's updates and support. From the point of view of the licensee, it is better not to allow the licensor to terminate the license altogether. The licensee may want to continue using the software for a period of time, without support or upgrades if necessary, until the licensee can replace it.

### **Maintenance**

As in franchising, software companies generally charge an initial fee as well as ongoing fees. The initial fee pays

for the software license. The ongoing fee is based on a second agreement, the maintenance or support agreement. Typically, the maintenance agreement will run from year to year. It typically allows the user the right to receive upgrades and new versions of the software, and it provides a defined level of support.

Maintenance agreements assure the licensor a steady cash flow and frequently end up costing more than the initial license fee. An annual maintenance fee of 15% or 17% of the initial license fee is not unusual, and it may be as low as 12%. The cost of maintenance over a multiple-year period is a subject that the licensee should negotiate at the outset. While the licensor will want to charge its then-current maintenance fee from year to year, it is to the licensee's advantage to put a cap on the increase in the maintenance cost for as many years as possible.

The licensee should also try to obtain contractual assurance that maintenance will continue for a specified minimum number of years. The licensor may decide without prior notice that it wants to discontinue a product or to replace it with an entirely new product, and to discontinue support for the obsolete product. This can happen suddenly, for example, if the vendor is acquired by another company. A licensee that is making a large software investment will want to know that it will have time to amortize its investment. Similarly, the licensee will want to know what happens if the licensee changes its hardware platform or network operating system.

A related issue is the extent to which the licensor will support past versions or releases. A licensee may not want to install a new version as soon as it is available. Installing a new version entails costs in the form of employee time and training. The licensee may simply have other priorities. In such cases, the licensee will want to know that the vendor will continue to support a prior version. Vendors will want to limit support, often to a fixed number of months, while licensees may want an assurance that the prior one or two versions or releases will be supported at any given time.

The level of support is another important question in maintenance agreements. How much support does the licensee require? For certain types of software, a licensee may want twenty-four hour telephone support with on-site assistance within four hours when telephone support cannot fix the problem. For other types of software, the licensee may be willing to pay for each support incident as needed. Licensors typically offer various levels of support for different products, for different prices.

## Changes in the Law

Courts and legislatures are trying hard to keep up with developments in the computer industry. One significant change in the works is a new Article 2B of the Uniform Commercial Code, which will cover software licenses, maintenance agreements and related agreements. While much can be said about the new Article 2B, only one point need be made here. Article 2B of the UCC is intended to fill gaps in private agreements on questions not covered by the written agreement of the parties, just as Article 2 of the UCC is intended to fill gaps in agreements for the sale of goods. Freedom of contract remains a fundamental principle in the UCC. While a review of all software license and maintenance agreements will be in order when Article 2B is enacted, the basic considerations discussed above will not change any time soon.

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## FRANCHISE WATCH

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Under its statutory mandate, the SBA may only provide financial assistance to small businesses. Because of franchisees' affiliation with larger corporations (most franchisors are not eligible for SBA guaranteed loans), the SBA had developed franchise-specific Eligibility Guidelines to ensure that the franchisee is sufficiently independent and that the franchisee — not the franchisor — would be the primary beneficiary of the loan. Accordingly, for a franchisee to be eligible for the SBA assistance under the current Guidelines, "the franchisor may not, either directly or through an affiliated entity or contract agent, subject Franchisee to such a degree of control that Franchisee does not have the independent right to both profit from its efforts and bear the risk of loss commensurate with ownership." The Guidelines, which pre-date plans for the Registry, address issues including franchise management, renewal, transfer and termination.

Unfortunately, because decisions regarding eligibility were made in each of the SBA's 69 regional offices, the Guidelines have been applied in an inconsistent manner. As a result, different offices often made conflicting eligibility determinations about identical franchise

agreements. Establishment of the Franchise Registry will eliminate this problem.

Under the new system, a franchisor seeking to be listed on the Registry as an eligible system, must review the Eligibility Guidelines and submit a completed Worksheet and application to FRANDATA along with an electronic copy of its UFOC (in either WordPerfect or Microsoft Word) and a \$2,500 initial application fee. FRANDATA will then review the application and, based upon the Eligibility Guidelines, make a recommendation to the SBA's Review Unit. The Review Unit may contact the franchisor to clarify outstanding issues prior to determining the franchise system's eligibility.

Once the decision is made, FRANDATA will list the franchisors that have been deemed "eligible" on an Internet Web site that it will create and maintain for the Registry. The public portion of the Web site will only list which systems have been determined to be eligible and initial dates of eligibility. A private portion of the Web site, accessible only to the SBA, SBA Participating Lenders and Certified Development Companies, will also include copies of the franchise and related agreements.

A franchisee in an "eligible" system that is applying for SBA financial assistance must provide the SBA regional office with a certification from the franchisor's counsel that there have been no revisions to the agreement(s) since the eligibility determination that are relevant to the Guidelines. The SBA loan officer processing the franchisee's application for financial assistance then need only access the Registry Web site to verify that the franchisee is eligible for SBA assistance, thereby obviating the need for local review of the franchisee agreement.

Franchisors will not be required to renew their listings on the Registry. If, however, they have made substantive revisions to the franchise or related agreements that may affect application of the Eligibility Guidelines, the franchisor must submit a \$500 "update certification" fee to FRANDATA along with a revised worksheet and clean and redlined versions of the relevant provisions.

Franchise UPDATE readers may obtain copies of the Eligibility Guidelines and Worksheet from FRANDATA at 1-800-793-8640 or by e-mail: FRANDATA@aol.com.

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