YOU DID WHAT? – POTENTIAL PITFALLS FOR THE FRANCHISOR

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Fair Use in the Electronic Age – Trademark Registration and Copyrights on the Internet, 1999, San Antonio Chapter Texas Society of Certified Public Accountants
Antitrust and Relationship Issues for Agricultural Product Dealers, 1994, Texas Agricultural Industries Association, South Texas Regional Meeting
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How to Protect Trade Secrets, 1990 San Antonio Intellectual Property Law Association Seminar
Franchising Opportunities And Pitfalls, Our Lady Of The Lake University 1989 and 1990
Franchising And The Business Lawyer, Texas State Bar Advanced Business Law Institute 1989
How To Recognize And Avoid Franchising, Houston Intellectual Property Law Association, 1988 Woodlands Institute
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I. INTRODUCTION

The purpose of this paper is to help the competent business attorney who does not yet have franchising experience anticipate and deal with potential pitfalls faced by small franchisors.

The structure of the paper is to first deal with the practical aspects of handling a small franchisor's crisis as its attorney and counselor within the bounds of ethical representation. As discussed below, the small franchisor is a more fragile enterprise and is subject to more potentially fatal threats than is commonly understood. Successfully guiding the small franchisor through its legally treacherous franchise expansion and possible "bet-the-system" franchise situations is different from the average attorney's corporate representation or business litigation experience.

The second portion of the paper outlines the different pitfalls a small franchisor faces and presents a treatment and preventative course of action for each. If there is anything that sets "Franchise Law" apart, it is its collection of many different legal issues usually left to specialists. Each of the listed pitfalls is the subject of numerous articles in its own right. The hoped-for effect of listing and briefly discussing them is to warn the novice franchisor attorney of their existence so he or she can judge which need to be prepared for ahead of time in their particular franchisor's circumstances.

This paper relies heavily on being one of other papers presented in this Franchise Program. Several important topics which only receive a cursory mention here are the primary subject of these companion papers.

II. YOUR FRAGILE SMALL FRANCHISOR CLIENT

While the new franchise attorney may aspire to represent McDonald's, Kentucky Fried Chicken, etc., as a practical matter, these giants are taken. They are fully staffed with experienced in-house attorneys who have relationships of decades standing with outside firms. Further, such systems have such a depth of resources that they have few bet-the-system cases.

In the real world, the franchisors the novice franchise attorney will likely initially represent are small franchisors. One major litigation defeat, one successful group of break-away franchisees, one state-wide rescission order, one Federal Trade Commission complaint, anything that substantially decreases income or increases expenses, may kill such franchisors.

To comprehend how this can possibly be true for a successful small franchisor, it is useful to access what the small franchisor's bankable assets are and are not. If a manufacturing company has a bad year, it can go to the bank and borrow against its building, equipment, inventory, orders in progress, etc. It is difficult for a small or even mid-sized franchisor to go to the bank and borrow to make payroll if cash flow is temporarily insufficient. The small franchisor has no tangible assets against which to borrow. The only security it has to offer the bank is the flow of checks it hopes will arrive in the future from its franchisees. If the franchisees do not send checks, the bank will not finance litigation to see if the franchise agreements are enforceable and the franchisees are solvent enough to pay judgments after exhausting themselves with litigation expenses. Without "bankable" assets, the small

franchisor's margin of safety is much narrower than anyone understands it to be – until there is a cash flow crisis.

For a small franchisor, cutting expenses means cutting franchisee support. Cutting franchisee support means less profitable franchisees which leads to less royalties, a greater likelihood of unaffordable litigation with unhappy franchisees and less favorable recommendations to prospective franchisees, which leads to fewer new franchise sales. In spite of the many legal aces the small franchisor holds and its large size relative to each individual franchisee, therefore, small franchisors have a practical inability to either significantly borrow or quickly cut expenses. Small franchisors live closer to the brink of a death spiral than is commonly understood.

Further, a lawyer dealing with a major problem in a franchise system must be aware of the peculiar legal and emotional aspects of franchise issues that are absent from other litigation and commercial tasks. Many of the issues listed below are both relatively unique to franchising and of paramount importance because of the legal, financial, and emotional structure of a small franchise system.

In spite of the many issues which require special legal expertise and experience, small franchisors are unable to pay tens of thousands of dollars a month in legal fees. Although the International Franchise Association (IFA) offers numerous services and opportunities to network with other franchisors, most small franchisors cannot or will not pay the $10,000 plus membership fee. The attorney must both work with and educate the small franchisor to triage the attorney's expensive services between critical work which can be performed within the franchisor's budget and work which should be performed in a perfect world but is not within the small franchisor's financial means.

Finally, small franchisors often fail. These casualties are masked by published statistics which extol the stability of franchising, but are skewed by large franchisor data. A recent research paper, Scott A. Shane, Explaining the Survival and Growth of New Franchise Systems, DuPree Center for Entrepreneurship and New Venture Development, Georgic Institute of Technology, tracked 138 firms in the population of new franchise systems established in 1983. Their survival rate over 10 years is as follows: 1983 – 100%; 1984 – 95.4%; 1985 – 94.6%; 1986 – 59.4%; 1987 –42.8%; 1988 – 42%; 1989 – 38.4%; 1990 – 29.7%; 1991 – 27.5%; 1992 – 26.8%; 1993 –24.6%. Further, although studies based primarily on large franchisors report that few franchisees fail, other studies have found franchise failure rates of 40%. Introductory Statement by Honorable John J. LaFalce (D.N.Y.) Chairman, Committee on Small Business Introducing H.R. 5253 and H.R. 5233, May 21, 1992, Bus. Fran. Guide (CCH), Extra Ed. No. 148, May 27, 1992. Objective reality probably lies somewhere between these dire figures and the cheery statistics promulgated by the IFA. Matter of Blenheim Expositions, Inc., FTC File No. 9323219, Bus. Fran. Guide (CCH) (1995) (Promoter of the IFA's trade shows advertised a 1992 Gallop Poll reported by the IFA that "A recent poll of 994 franchise owners showed a 94 percent success rate and an average pre-tax income of over $124,000." The FTC complaint states "in truth and in fact, the Gallop Poll of franchisors owners conducted in 1991 does not prove representations: [the above representation] for reasons including but not limited to the following. (A) The poll participants were asked to report their annual gross income before taxes, and were not asked to deduct business expenses; (B) The poll participants were drawn

exclusively from a list of current franchise owners, and no former franchise owners were polled; and (C) The poll included a disproportionate number of owners of multiple franchise locations." The promoter consented to being enjoined from making such representations.)

The new franchisor attorney needs to be aware of these practical matters to properly assess how to best represent each small franchisor client.

III. OH MY GOD! (DISASTER USUALLY ARRIVES WITH A THUD)

A. Organization Leads to a Plan

The temporary restraining order, FTC complaint, multiple franchisee suit, or credit line cancellation rarely comes at a good time. FTC v. Int'l Computer Concepts, Inc., Bus. Fran. Guide (CCH), part 10,578 (N.D. Ohio, 1994) (court granted FTC an ex parte temporary restraining order freezing the franchisor's assets and permitting expedited discovery). Management is comprised of flesh-and-blood people. When faced with a confidence-shaking, "the ship is sinking" disaster, some employees may react counter-productively. Blame may be transferred down the line. Some persons will run for cover. You need to know that because of the dynamics of a franchise system, everything said about the crisis at the franchisor's headquarters will be repeated and embellished throughout the system. Franchisors joke that communication by tell-a-franchisee is speedier than by telephone.

The attorney's first function when notice of a calamity arrives is sometimes to act as a counselor by using the attorney's perceived knowledge of the law's black arts and aura of legal powers to create confidence and get the franchisor's employees focused on uniting in a single plan to fight the external enemy. The worse the disaster, the sooner you should arrive at the franchisor's headquarters. Whether fashioned as comforting reassurance, cold confidence, or arrogance, you must be seen as either having a plan or organizing a plan for the franchisor to fight its way out. The necessity for your physical presence is proportional to the franchisor's fragility.

Attorneys engage in formal and informal general problem solving from working out the family's finances to deciding how to best present their client's case at trial. Nevertheless, when presented with a problem that stuns everyone, including you, often it is useful to go back to basics in an attempt to impose order: (1) Collect and evaluate the facts; (2) Identify and define the problem; (3) Identify and evaluate alternatives; (4) Decide on a plan; and (5) Execute the plan. Sometimes the best thing to do is to force yourself and franchisor's management to literally, visibly, and mechanically work through these steps. The mere fact that you are seen to be organizing a plan will help focus people and calm the Chicken Littles of the world. In as little as a few hours, organizational emotional stability and confidence may be restored and it will be time to leave. Your presence and support during this brief time, however, is part of what the small franchisor client needs and is included in your job description as counselor.

B. Your Role as an Attorney

Your function with the franchisor is not only to serve as counselor but also as attorney. Each attorney informally takes the following steps when resolving any legal problem: (1) Learn the facts; (2) Learn the applicable law; (3) Apply the facts to the law, i.e., identify and evaluate

alternatives; (4) Recommend a course of action to the client; and (5) Implement the client's decision. Each of these steps is subject to reams of elaboration with which all competent attorneys are familiar.

Learning the applicable law and acquiring specialized franchise library resources are necessary to practice franchise law. The novice franchise attorney must spend numerous unbillable hours learning the applicable law, the pitfalls listed below and, for each particular real world problem, the applicable law of the subject states. Banbury v. Omnitrition Int'l, Inc. Bus. Fran. Guide (CCH), part 10,705 (Minn. Ct. App. 1996) (Minnesota law applied even though distribution agreement stated that it was governed by Texas law.) This includes trademark, antitrust, state relationship laws, noncompetition, vicarious liability, conflict of laws, trade secret, copyright, bankruptcy, advertising restrictions, FTC regulations, state "baby FTC" statutes, etc., as well as state and federal franchise regulations, several of which are the subject of a separate legal specialty, and is an awesome task. Any can be the downfall of a small franchise system. The contract and tort law applied by each jurisdiction that the franchisor and its franchisee's operate in and local, state, and federal regulations concerning the subject line of commerce all affect the franchisor.

Every franchise attorney necessarily has access to Commerce Clearing House's the Business Franchise Guide, the franchise law's recognized indispensable collection of franchise cases, statutes, regulations, governmental interpretative opinions, etc. Most franchise attorneys belong to and attend the annual meetings of the American Bar Association Forum Committee on Franchising. Its published Annual Forum materials and its Franchise Law Journal are excellent. The network with other experienced franchise attorneys you should create will be called on when questions outside of your expertise arise. Other useful materials are: Robert A. Purvin, Jr., The Franchise Fraud, How to Protect Yourself Before and After You Invest (1994) (because you will often be called on to represent franchisees); Michael J. Lockerby, Franchise Law Bibliography (2nd ed. 1993); L.W. Michael Garner, Franchise and Distribution Law and Practice (1995). Numerous franchising specific newsletters and magazines exist.

IV. COLLATERAL ESTOPPEL

A. Legal Collateral Estoppel

One of the wonderful advantages of franchising that makes it possible for the franchisor and its franchisees to succeed in the marketplace against large chains and independent businesses is that the successful franchise system is constructed so the franchisor and its franchisees work together as a single competitive unit. The different franchisee's employees wear the same uniforms. Their business marquees are identical. Their suppliers, store designs, recipes are identical. The resultant cost savings, market presence, critical mass, etc. which help make the franchisees profitable are the very reason for the franchise system's success. The franchisor accomplishes this by using identical contracts, requirements, correspondence, operating manuals, etc. with each of its many franchisees.

Unfortunately, this fact pattern makes the franchisor particularly vulnerable to offensive collateral estoppel. The doctrine of collateral estoppel states that once a final judgment is entered against a party upon a particular set of facts and legal conclusions, that party is estopped

from re-arguing those facts and legal conclusions against third parties who present the same facts and legal arguments in other suits.

> "Relitigation of an issue will be barred by collateral estoppel if '(1) the facts sought to be litigated in the first action were fully and fairly litigated in the prior action; (2) those facts were essential to the judgment in the first action; and (3) the parties were case as adversaries in the first action.' [citations] For collateral estoppel to be invoked, it is only necessary that the party against whom the plea of collateral estoppel is being asserted to be party or in privity with a party in the prior litigation. Mower v. Boyer, 811 S.W.2d 560 (Tex. 1991) (emphasis that of the court)."

If, for example, any franchisee obtains a final, unappealable judgment against the franchisor that the franchisor's covenant not to compete is unenforceable or its trademark is unenforceable, all similarly situated franchisees in the system will argue that their franchise agreement and their facts and circumstances, vis-à-vis the franchisor, are legally the same as the winning franchisee's franchise agreement, facts and circumstances vis-à-vis the franchisor. Thus, even if twenty franchisees were previously unsuccessful in getting the covenant not to compete or trademark invalidated, one successful franchisee can possibly bring the entire franchise system down.

The collateral estoppel doctrine can make otherwise isolated franchise cases concerning system-wide issues "bet-the-system" cases. This puts enormous pressure on the franchisor to pick its fights carefully, since it cannot afford to lose even once. Suits based upon a specific franchisee's facts, such as its failure to pay royalties, do not create this problem.

B. Emotional Collateral Estoppel

Viewed emotionally, small franchise systems are extended families populated by hard-driving, motivated individuals, each of whom believes with 150 percent certainty that he or she knows what is right for their business. Franchisors will tell you in private that franchisees must be treated like children, i.e., favors extended to any franchisee must be extended to all franchisees; franchisees cannot keep a secret, franchisees are constantly pushing to see what the bounds of permitted conduct are, etc. The franchisor often sees himself or herself as the parent and the franchisees as the children. Franchisees often take a similar view and, to a degree, this perception is warranted. Few relationships create stronger emotions, both positively and negatively, than those within a family.

Franchisees quickly become categorizable within the franchise family, both by their individual characteristics and the groupings they form. Some franchisees are loyalists to the franchisor cause. Some franchisees are against anyone and everyone who tries to tell them how to operate their business, however appropriate the advice or instructions. Others will seek to create their own grouping of like-minded dissidents who want to operate their businesses another way. These personalities are present in any franchise family.

On the one hand, franchisees are the franchisor's customers, with all that this implies. The franchisor must create and keep the franchisees' loyalty by providing superior services

beyond what is required by the franchise agreement and generously extending assistance and favors from time to time. The discussion below concerning franchisee advisory councils and franchisee associations should be reviewed in considering how your particular small franchisor should structure its relationships with the franchisees to best promote friendly cooperation and discourage back-biting and resentment. As much of a friend as the franchisor should be with the franchisees, however, the franchisees must believe in their gut that the franchisor will foreclose on their stores and livelihoods if they do not timely send in their royalty checks. If disrespect for the franchise system's rules becomes disruptive and warnings are not sufficient to get the franchisees back into compliance, then termination of an uncooperative franchisee may be required. This may be done as an example to induce other franchisees to comply rather than for any expected monetary benefit from the designated franchisee. Spending several thousands or even tens of thousands of dollars in attorneys' fees grinding down the single uncooperative franchisee in litigation may be a worthwhile franchisor investment if the defendant franchisee's complaints to the other franchisees about the litigation cause the other franchisees to renew making full, timely royalty payments and to comply with the system's rules.

V. THE ATTORNEY'S ROLE

A. Proactive Problem Solving

The above discussion assumes you are called in after the train wreck. You are more useful and less expensive to the franchisor in the long run if you develop a relationship with the franchisor that permits you to sometimes informally spend time at headquarters for no good reason other than to chew the fat and be nosey. This often leads to discovery of issues that are on or over the horizon. You can then alert management and develop strategies for dealing with the issues before they become more expensive immediate problems.

For example, since you are aware of how awful the penalty is for selling franchises under a trademark that infringes a competitor's federally registered trademark, as discussed below, an employee's casual mention of a territorially remote competitor with a similar name may cause you to informally investigate and evaluate the potential problem before it arrives in the form of a certified demand letter from a senior user with an incontestable federal trademark registration (see VII, E, 3, Unusable Trademark below). The key is to know what potential problems to look for and have a good enough relationship with the franchisor to "waste time" scouting them out before they arrive.

You cannot draft legal documents which will make the franchise system successful and make money for the franchisor if the franchisees do not both get more value from the franchisor than the money they pay the franchisor and emotionally feel loyalty to the franchisee system and its franchisor. These emotional, economic, and practical considerations need to be weighed, together with the usual legal aspects, when recommending a course of action to the small franchisor. Since you are peculiarly experienced with and are knowledgeable about the potential pitfalls, you can help your franchisor client avoid them.

B. Educate the Client

1. Emphasize Personal Liability. An essential tool in getting franchisor management to effectively police against franchise sale misrepresentations and other franchise law violations is to educate the individuals in the small franchisor's management team that they may be personally liable for any franchise sales that a jury subsequently finds were made by misrepresentation or in violation of applicable franchise law. United States v. The Building Inspector of America, Inc., Bus. Fran. Guide (CCH), part 10,695 (D.C. Mass. 1995) (Franchisor's president liable for franchisor's UFOC misrepresentations because he had ultimate managerial control of the franchisor and was, or should have been, aware of the misrepresentations. His professed ignorance of the violations and his responsibilities under the FTC Rule was not a defense).

The parallel to securities law should be emphasized to everyone. A full understanding of possible personal civil and criminal liability encourages management to aggressively police their franchise sales by (1) accurately disclosing the information required to be disclosed by all relevant federal and state laws in accordance with the required forms, deadlines, procedures, registrations, etc., and (2) not failing to disclose material information.

A portion of the author's standard handout to small franchisors follows:

> "The UFOC is your personal offering circular. If anything in it is incorrect, is not completely descriptive, or if any facts that would be material to a prospective franchisee's decision to purchase are not included then you and anyone else who participates or directs the sale may be personally liable to the Attorney General's Office of the relevant state, the Federal Trade Commission and any injured franchisees who rely on it. Omissions of material facts are as deadly as inclusions of incorrect information. While I have tried to include everything that is material you need to carefully read the UFOC as if your personal liability depends on it because it does. Using an incomplete or inaccurate UFOC is a criminal violation in some states.
>
> * * *
>
> "First Personal Meeting Rule, Ten Day Rule and Five Day Rule" "The law not only prescribes "what" you tell prospective franchisees, it also prescribes how and when you tell them. The "what" and "how" are your UFOC. Verbally communicating required information is not enough.
>
> "The three "when" rules are:
>
> "(1) First Personal Meeting Rule. A prospective franchisee must be given the UFOC at the first personal meeting for the purpose of offering him a franchise.
>
> "(2) Ten Day Rule. The Franchise Agreement cannot be signed until ten business days (weekends and holidays don't count) after the prospective provably gets the UFOC.

> "(3) Five Day Rule. The Franchise Agreement cannot be signed until five business days after the Franchise Agreement is completed in every respect (i.e., all blanks filed in)."

These rules are the subject of other papers in this Franchise Program.

While clients universally want to avoid the cost of such franchise law compliance, the way to obtain their attention is to educate them that the penalty for noncompliance with franchise law can be destruction of the business and personal and criminal liability for officers and controlling persons. Wheeler v. Box, 671 S.W.2d 75 (Tex. App.--Dallas 1984) (officers personally liable); Dollar Sys., Inc. v. Avcar Leasing Sys., Inc., 890 F.2d 165, Bus. Fran. Guide (CCH), part 9498, (9th Cir. 1989); Avery v. Solargizer Int'l, Inc., 427 N.W.2d 675 (Minn. Ct. App. 1988) (officers must have knowledge or reasonable grounds to know of facts to be liable); Courtney v. Waring, 237 Cal. Rptr. 233, (Cal. Ct. App. 1987; Sutherland, The Risks and Exposures Associated with Franchise Noncompliance, 42 The Bus. Lawyer; 369 (1987).

Certain misrepresentations and franchise law violations comprise criminal violations. U.S. v. Lawrence E. Jaspan, Bus. Fran. Guide (CCH), part 9773 (1991) (Franchisor sentenced to three years, $1,400,000 in redress to consumers and $870,000 in civil penalties); People v. Mott, 189 Cal. Rptr. 589 (1983) (Defendant who failed to provide disclosure statement unsuccessfully argued he was unaware the law required them. "Willful" criminal violation held to mean a willingness to commit the act and not intent to violate the law).

FTC enforcement actions typically make the franchisor's officers jointly and severally liable for consumer redress and civil penalties. FTC v. Nat'l Business Consultants, Bus. Fran. Guide (CCH), part 9594 (E.D. La. 1991) (Franchisor and its president liable for $3,019,337 redress. [Later held in The Matter of Robert Nomer, Debtor, Bus. Fran. Guide (CCH), part 9992 (Bank's Ct. E.D. La. 1992) to be a non-dischargeable debt in bankruptcy]); United States v. Fed. Energy Sys., Bus. Fran. Guide (CCH), part 8433 (C.D. Cal. 1985), (franchisor and its offices jointly and severally liable for $3.0 million in customer redress and $1.6 million in civil penalties).

For an individual to be liable under the FTC Act, it must be shown "that the individual directly participated in the practices or acts complained of or that the individual had the authority to control the acts or practices complained of and had some knowledge of the practices or acts." FTC v. Solomon Trading Co., Inc., 1994-1 Trade Cas. (CCH), part 70,627 (D. Ariz. 1994) at 72, 408. However, "knowledge can be proven by showing that the defendant had 'actual knowledge of material representations, reckless indifference to the truth or falsity of such misrepresentations or an awareness of a high probability of fraud along with an intentional avoidance of the truth.'" FTC v. Amy Travel Service, Inc., 875 F.2d 564, 574 (7th Cir. 1989).

All franchisor personnel should be educated to understand that it is better to lose any sale than to incur the probability of future litigation. Letters from the franchisor's president to all sales employees, agents, and brokers; memos on the bulletin board; written agreements of all franchisor personnel, agents, and brokers to not make unauthorized sales claims, recorded debriefings of prospective franchisees at the time of signing the franchise agreement and other such devices may all help avoid future litigation by reducing questionable conduct. They may

also be admissible at trial on the issues of punitive damages, personal liability, and criminal liability.

The acts you should take to bulletproof yourself from failure of due diligence and malpractice claims will vary from memos to the file to letters to the franchisor and its controlling persons. Your taking visible measures to limit your liability will also help impress the client with the need to protect him or herself by provably making full disclosure and being in full compliance.

2. Franchise Business Advice. The typical client knows more about his or her line of commerce than the attorney and primarily wants you to "paper over" his handshake deals. That is what attorneys are for. The start-up franchisor client, however, is in a new line of commerce, franchising, that the franchise lawyer knows better than the client. The franchise lawyer has structured other franchise systems, prepared other franchise agreements and offering circulars, dealt with and litigated with disgruntled franchisees, worked with successful and unsuccessful franchisors, etc. The start-up franchisor client has none of these experiences. Like anyone in a new situation, he or she initially has no common sense to rely on. This puts the lawyer in an awkward role. If you do not offer sound franchising business advice, the franchisor may proceed without the benefit of experienced advice at all.

On the other hand, business functions and advice are generally inappropriate for the lawyer. Further, the lawyer cannot slide into de facto management without creating an indefensibly high bill for "legal services" and losing his or her protected status as a "mere" attorney. The franchisor may join the International Franchise Association and attend its quarterly regional roundtables, hire consultants, socialize with other franchisors, etc. Norman D. Axelrad et al, Franchising, A Planning and Sales Compliance Guide (1987); Steven S. Raab et al., Blueprint for Franchising a Business (1987). The Franchise Option: How to Expand Your Business Through Franchising, by Kathryn L. Boe, William Ginalski, and D. Henward, III (1987), are useful concerning this subject. There is no pat answer to this dilemma. The best that can be done is to be continually aware that it is a problem.

C. You Are Not The Client

The chief executive officer of your small franchisor was first successful in his or her own small businesses then successfully grew that business and then successfully expanded the business further as a franchisor telling other people how to run their businesses. He or she is outstandingly competent in their field. Understandably, based on this unchecked track record, he or she is very self-confident. If they were not very competent and self-confident, they would not have been able to do what was necessary to create a successful franchise system from the single store they started from scratch twenty years ago. Such individuals are not always extremely amenable to a novice franchise lawyer's advice to change, slow down or back up. This is particularly true when the legal advice is to spend more money than is available on franchise law compliance. This heightens the possibility that your ethical obligations, seldom tested typical client representations, will come to the fore in representing the small franchisor.

Your job is to give the client your independent, competent legal advice and to then follow the client's lawful, ethical instructions. This high-minded principle can become blurred when

the client "must" sell the additional franchise to a willing buyer in a state where the franchisor does not yet have the necessary franchise registration to make payroll and requires your assistance to achieve that result with the least possible adverse consequences. The franchisee may be successful and there may be no adverse consequences. If adverse consequences occur, they may not happen until some months or years down the road after the subject franchisee has failed and sued or complained to the state franchise administrator. In the meantime, the franchisor met payroll and may possibly have gone on to become a successful large franchise system capable of taking the hit from the subject franchisee. On the other hand, in State of XYZ v. Everyone, for willful criminal violations of the state's franchise statutes, the several individual defendants who participated in the sale will wonder aloud why you let them get into such a predicament.

Where do you fit into this maelstrom? It is often useful to repeat the mantra that your job is to give the client independent, competent legal advice and to follow the client's lawful, ethical instructions. You are not the client. You are not a hit man for the client. You have duties to each state, the law, your own code of honor, your law firm, your family, etc. (not necessarily in that order). Most clients' survival decisions are ultimately "business decisions" that are above your pay grade. Your legal advice is only one of several components to their decision. The best advice to the attorney caught in this bind is to visualize what his or her conduct will look like to a jury and to document the cautions given to the client. Any meeting or telephone call that makes you queasy should be followed up with a letter evaluating the alternatives and their possible legal results.

D. <u>Order of Awfulness</u>

The franchise attorney for a small franchisor may be confronted with problems that have potentially fatal consequences. For example, your franchisor or its commission-paid salesmen may have "saved" money and time by selling franchises without a UFOC or without registering in the applicable state. In addition to private suits brought by unhappy franchises, such sales may cause the state franchise administrator to require a statewide offer of rescission or to seek civil remedies and criminal penalties against the franchisor and its controlling persons. Non-compliance may make the franchisor and its controlling persons liable to the Federal Trade Commission for fines of $10,000 a day, consumer redress, etc.

Since the small franchisor's principal officers typically make or participate in franchise sales, any judgment for franchise sale fraud and misrepresentation will likely include them as defendants. Thus, since the small franchisor typically is cash poor and has few bankable assets, any significant adverse judgment may bankrupt not only the franchisor but also its principals.

If a problem is sufficiently horrible, you need to evaluate the possible alternatives and their likely consequences against an imaginary "order of awfulness" to properly advise the franchisor.

(a) Criminal conviction with jail time

(b) Non-dischargeable judgment that bankrupts the franchisor and the franchisor's principals

(c) Dischargeable judgment that bankrupts the franchisor and the franchisor's principals

(d) Result that immediately bankrupts the franchisor

(e) Result that will slowly but invariably bankrupt the franchisor

(f) Result that mangles the franchisor but leaves it some hope of survival

(g) etc. to risk-free and expense-free complete victory

Discussing these awful possibilities with the small franchisor is not only a useful proactive educational method but is also sometimes needed to decide among alternatives.

E. Toolbox of Legal Alternatives

The franchisor has numerous choices concerning how to deal with franchisees that have a legitimate complaint. The franchise attorney should be familiar with each of the following listed alternatives.

(1) The franchisor's chief executive may personally visit and talk it out with the aggrieved party. This may include apologizing and promising to do better and to make it up later. This is an under-used tactic considering its potential for success and zero monetary cost. The possibility of creating admissions against interest which make the problem worse needs to be considered.

(2) Informally trade out the complaint with non-monetary carrots and sticks--example, grant a first right of refusal on an adjacent territory in exchange for forgiveness or agree to overlook the franchisee's failure to comply with a franchise agreement term. (See waiver and ratification, below.)

(3) Delay and hope for

(a) Statute of limitations. Knowledge of all applicable causes of action and state laws is critical here, as the subject statutes of limitation can be anywhere from thirty days to four years, depending on the problem and the jurisdiction. Hays v. Mobile Oil Corp., 930 F.2d 96, Bus. Fran. Guide (CCH), part 9832 (1st Cir. 1991) (Massachusetts baby FTC Act claim barred by one-year contractual limitations clause). Chico's Pizza Franchisees, Inc. v. Sizemore, 685 F.2d 440, aff'd., 544 F.Supp. 248, Bus. Fran. Guide (CCH), part 8041 (E.D. Wash. 1983). Note that "[T]he statute of limitations does not begin to run until the claimant discovers or should have discovered through the exercise of reasonable care and diligence the facts establishing the elements of his cause of action. Willis v. Maverick, 760 S.W.2d 642, 646 (Tex. 1988) and that a statute of limitations defense may be avoided if you sue the franchisee and the franchisee counterclaims within thirty days of answering, Tex. Civ. Prac. & Rem. Code, 16.069, and that concealment may cause tolling. Conmar

Corp. v. Mitsui & Co. (USA) Inc., 858 F.2d 499, 505 (9th Cir. 1988), cert. denied, 488 U.S. 1010 (1989) (mere concealment will trigger tolling where defendant had a duty to disclose).

(b) Waiver. Texas attorneys often forget that non-DTPA claims can be waived. Physician's Weight Loss Centers of America v. Creighton, Bus. Fran. Guide (CCH), part 9829 (D. Oregon 1991) (integration clause barred misrepresentation claim), contra, West Coast Video Enterprises, Inc. v. Ponce De Leon, Bus. Fran. Guide (CCH), part 10,102 (N.D. Ill. 1991).

(c) Ratification

(d) Equitable estoppel

(e) The aggrieved franchisee sells out and goes away

(4) Cause waiver, ratification, or estoppel (remember that these are only effective against sins the franchisee was aware of when the franchisee makes the affirming act)

(5) Find a buyer for the unhappy franchisee's business

(6) Undo the complained-of act

(7) Stonewall

(8) Threaten suit

(9) Sue the franchisee first in your home jurisdiction and quickly settle or litigate to an uncollectible favorable judgment after spending a king's ransom on the suit (if you are lucky)

(10) Pay money for a release

(11) Grant an individual rescission

(12) Offer state-wide rescission (after consulting applicable state law, and obtaining the state law, and obtaining the state franchise administrator's approval)

(13) Get sued in a distant adverse forum, pay tens of thousands of dollars in attorneys' fees, and lose big

No computer program can be written to properly take into account the innumerable and indefinable factual and legal factors that determine how to choose between these alternatives. Finances, honor, emotion, applicable state law, momentum, the effect of anticipated future events, the effect of past events, whether a key player has personal problems, bad information, bad advice, bad luck, etc., all come into play. The best that can be done is to be aware of these alternatives (and create more, if possible) and to view decision-making as a process of collecting information and weighing the alternatives. It is very useful to talk over difficult issues with another franchise attorney who is not involved.

VI. TEXAS DTPA AND BOA HIGH-LIGHTS

A. Deceptive Trade Practices Act

For a franchisee to prevail in a Deceptive Trade Practices Act (DTPA) action, the franchisee must prove consumer status, a DTPA violation, producing cause and damages. To qualify as a consumer (1) the plaintiff must have sought or acquired goods or services by purchase or lease, and (2) the goods or services purchased or leased must form the basis of the complaint. DTPA §17.45(4); Melody Home Mfg. Co. v. Barnes, 741 S.W.2d 349, 352 (Tex. 1987). The purchaser or franchise is typically held to be a consumer. Bonanza Restaurants v. Uncle Pete's, Inc., 757 S.W.2d 445 (Tex. App. 1988); Wheeler v. Box, 671 S.W.2d 75 (Tex. Civ. App.--Dallas 1984, no writ); Woo v. Great Southwestern Acceptance Corp., 565 S.W.2d 290 (Tex. Civ. App.--Waco 1978, writ ref. n.r.e.); contra Meineke Discount Muffler Shops, Inc. v. Wesley Jaynes, Bus. Fran. Guide (CCH), part 9959 (S.D. Tex. 1991) (It is not clear whether the holding is broadly [and erroneously] that a franchise is not a good or service as a matter of law or that the subject franchisee purchased a trademark license (the franchise) from a prior franchisee and not the franchisor as a finding of fact); Fisher Controls Int.'l, Inc. v. Gibbons, ____ S.W.2d ____ (Tex. App.--Houston, 1995) (purchase of a "representative agreement" held to be the purchase of an intangible right not making the purchase a DTPA "consumer"); Crossland v. Canteen Corp., 711 F.2d 714 (5th Cir. 1983) (intangible contract rights not a "good" or a "service." Id. at 721).

Since privity is not required for DTPA consumer status, Flenniken v. Longview Bank & Trust Co., 661 S.W.2d 705, 707 (Tex. 1983), the franchisor's officers, directors, etc., may be liable to the franchisee.

Sales representations may be DTPA violations if they do not prove true for the particular plaintiff franchisee since many §17.46(b) representations do not require intent to deceive or knowledge of their falsity. Pennington v. Singleton, 606 S.W.2d 682, 689-90 (Tex. 1980); Concorde Limousines v. Moloney Coachbuilders, Inc., Bus. Franchise Guide (CCH), part 9027 (5th Cir. 1987) (Seller's subjective understanding of the meaning of his statement is irrelevant); Allais v. Donaldson, Lufkin & Jenrette, 532 F.Supp. 749, 751-752 (S.D. Tex. 1982). Further, most common law defenses are inapplicable to DTPA actions, Weitzel v. Barnes, 691 S.W.2d 598, 599-600 (Tex. 1985). Alvarado v. Bolton, 749 S.W.2d 47, 48 (Tex. 1988) (merger doctrine does not defeat DTPA action). First Title Co. v. Garret, 860 S.W.2d 70 (Tex. 1993) (Franchisees are precluded from waiving the protection of the DTPA, §17.42(a)(1).

Although the DTPA §17.46(B)(23) prohibition against failing to disclose material information requires a showing of intent, §17.46(b)(23); Freeman v. Greenbriar Homes, Inc., 715 S.W.2d 394, 397 (Tex. App.--Dallas 1986, writ ref'd, n.r.e.), it may be persuasive against franchisors who fail to provide a disclosure statement if presented to the jury together with The Rules' disclosure requirements. Century 21 Real Estate Corp. v. Home Town Real Estate Co., 890 S.W.2d 118 (Tex. App.--Texarkana 1994) "Section 436.1 provides that the failure to furnish a prospective franchisee with the specified information is an unfair or deceptive act of practice within the meaning of the Federal Trade Commission Act . . . . The DTPA applies to an act or practice prohibited by an FTC rule or regulations." Id. at 125. Texas Cookie Co. v. Hendricks & Peralta, 747 S.W.2d 873, 877 (Tex. App.--Corpus Christi 1988); Rodopoulos v. Sam Piki Enter.,

Inc., Bus. Fran. Guide (CCH), part 9741 (Ala. S.Ct. 1990) (jury permitted to consider FTC Rule in determining franchisor's duty of disclosure); Morgan v. Air Brook Limousine, Inc., 510 A.2d 1197 (N.J. Super. L. (1986) (violation of The Rule violated New Jersey's Consumers Fraud Act); c.f. Big H Auto Auction, Inc. v. Saenz Motors, 665 S.W.2d 756 (Tex. 1984), contra LeBlanc v. Delt Center, Inc., 509 So.2d 134 (La. App. 1st Cir. 1987); Symes v. Bahama Joe's, Inc., Bus. Fran. Guide (CCH), part 9191 (D. Mass. 1988); Church's Fried Chicken, Inc. v. McNeely; Cause No. SA88CA0062 (W.D. Tex. 1988) (Jury heard evidence of The Rule's requirements but franchisee not allowed jury questions or instructions concerning it).

Scienter is not needed for a sale to be unlawful because it is unconscionable. Chastain v. Koonce, 700 S.W.2d 579, 583 (Tex. 1985); Griffith v. Porter, 817 S.W.2d 131, 136 (Tex. App.--Tyler 1991, no writ); Segura v. Abbott Laboratories, 873 S.W.2d 399 (Tex. App.--Austin 1994).

Recent cases to the effect that breaches of representations of performance, which performance is required of the seller under the parties' contract, sound only in contract and not under the DTPA have significant reduced the DTPA's reach. Crawford v. Ace Sign, 39 Tex. Sup.Ct.J. 296 ____ S.W.3d ____ (Tex. 1996). The discussion in Autohaus, Inc. v. Aguilar, 794 S.W.2d 459 (Tex. App.--Dallas 1990), aff'd, 800 S.W.2d 853 (Tex. 1991) concerning "the levels of the knowledge of the buyer and seller" Id. at 463, and "whether or not its [the salesman's] correctness is a matter of which either of the parties can judge as well as the other, upon which the buyer can, and may, reasonably be expected, in the exercise of ordinary diligence, to have formed his owned opinion Id., and "whether the statement is specific enough to be an actionable misrepresentation under the DTPA" Id. at 464, will be used in support of many franchisor representations which failed to come true. Further, the DTPA's 1995 amendments will substantially affect its impact on franchising. (1) Consumer waivers of the DTPA are now possible (§17.42); (2) the "gross disparity" method of showing unconscionability is deleted (§17.45); (3) it is unclear whether a franchisee's total real estate build-out and lease obligation and full franchise term royalty obligation will be considered in determining the "total consideration by the consumer" with respect to the DTPA's new $100,000 and $500,000 transaction limits, and (4) several new limitations on damages may lessen the franchisee's recovery.

B. Business Opportunity Act

A Texas Business Opportunity Act's (BOA's) (Tex. Rev. Civ. Stat. Ann. art. 5069, §16.01 et seq.) cause of action requires proof that the purchaser purchased a business opportunity, a BOA violation, producing cause, and damages. BOA §16.15(b) and DTPA §17.50(a). Franchisors rarely comply with the BOA's filing and disclosure requirements, choosing instead to rely on the §16.06(1)(H) exemption based on compliance with 16 C.F.R. §436 ("The FTC Rule"). If the franchisor then fails to comply with The FTC Rule, the franchisee can claim a BOA violation. This provides the franchisee plaintiff with an additional DTPA §17.46(b) "laundry list" jury question together with a platform for arguing that what happened to the franchisee was exactly the kind of abuse this special statute was enacted to prevent. To prove anything beyond a nominal violation of the BOA due to the franchisor failing to provide a formal disclosure statement, however, nondisclosure must be a "producing cause" of damages. Because the BOA's disclosure requirements are poorly designed and merely provide

mostly formal information even if complied with, the BOA often is not as much help to the franchisee as would appear at first glance.

The BOA's requirement of financial disclosure by the seller "updated to reflect material changes in seller's financial condition" §16.09(5) is a typical basis for attack. Since most franchisors orally make "any statement concerning sales or earnings that may be made through this business opportunity," failure to comply with the disclosure requirements this triggers may provide a producing cause of damages. §16.09(10). Miksch and M.I.K., Inc. v. T-shirts Plus, Inc., No. 85 AP-517 Slip Opinion 1985 W.L. 4154 (Ohio App. Dec. 3, 1985) (T-shirts Plus presented the prospective franchisee with a chart containing sales, costs and net profit ranges for six hypothetical stores. This was held an earnings claim because it was an "oral, written or visual representation to a prospective purchaser concerning potential sales, income or gross or net profit . . . ." [Interpreting "earnings claim" under the Ohio Business Opportunity Protection Act.] Bailey Employment Systems, Inc. v. Hohn, 545 F.Supp. 62 (D. Conn. 1982) (Statement of average annual sales volume was an earnings claim.) If the franchisor provides prospective purchasers with reprints of favorable media articles, he may be found to have adopted any statements made in the articles as its own. Because the DTPA's remedies are adopted by the BOA, the applicable statute of limitations is two years.

VII. NON-EXHAUSTIVE LIST OF POTENTIAL FRANCHISOR PIT-FALLS

A. Franchise Sales – Practical Problems

1. Over-Expansion

a. Problem. Too many franchises sold were too soon and too far away. This is a typical problem, as the business person who has just begun franchising may not appreciate until too late that going into franchising is more like entering an entirely new business than merely extending his current successful business. The entirely new business needs to be capitalized. Knowledge needs to be gained about the franchising line of commerce. Procedures need to be created through trial and error over time to make the new line of business work. A substantial monetary and time investment needs to be made in franchise law compliance. Support staff has to be hired and trained for franchise sales, initial training and ongoing support. Operations manuals must be prepared. Ideally, this is all in place before franchises are sold. Initial franchises and distant franchises will likely be unprofitable to service for some time. Premature franchise sales may doom the entire enterprise. Legal expenses will be high as long as the franchise system continues to expand until much later in the franchise system's existence. The legally-required annual audited financial statements will cost thousands of dollars each year. Even simple items such as reviewing and approving each franchisee's specific adaptations of the system's design plans to its site etc., may require professional services at a cost to the franchisor. These ongoing franchising expenses may exceed royalty income generated from the franchise system until enough mature franchises are peacefully paying royalties each month. Until then, making payroll may be dependent on obtaining more initial franchise fees from the sale of new franchises unless this problem was anticipated and the franchisor properly capitalized.

b. Treatment. The obvious treatment is to stop selling franchises that cannot be profitably serviced with the franchisor's current resources. (Remember, "The first

rule of getting out of a hole – 'Stop digging'" [example of the attorney's metaphor as discussed above]). From the attorney's point of view, no additional franchises should be sold until state registrations are obtained, proper staffing and procedures are put into place, etc. Unfortunately, like an endless pyramid scheme, franchise systems which have this problem are often in the predicament of needing additional initial franchise fees to pay the overhead of supporting the remote franchises they have already sold. The typical compromise treatment is to cease selling remote franchises and to emphasize selling franchises within and on the edge of the franchisor's primary regional expansion zone.

In reviewing the above "tool box" of legal alternatives, the alternative for avoiding legal problems with the current remote unsupportable franchisees that is most hopeful is to continue sending them whatever level of support that can be spared with an eye toward the benefits of delay. Many state franchise laws have a one year statutes of limitations. There are numerous two year statutes of limitations. The defenses of ratification, waiver, estoppel, etc. may slowly gel, particularly if the franchisor is on the lookout for ways to create ratification situations. For example, the franchisor may offer the remote franchisee a temporary royalty abatement in exchange for the franchisor temporarily providing fewer services. This may both keep the franchisee in the fold and effect a ratification concerning issues the franchise has been provably previously apprised of.

c. **Prevention**. The best way of preventing a young franchisor from over-expanding is to get to the franchisor before it begins franchising and to explain why taking initial franchise fees from too many remote franchisees too soon leads to a death spiral. Your explanation of the high legal cost of getting state franchise registrations in many remote states and the likelihood of state franchise administrators imposing an impound on a franchisor who is extremely light on experience and finances may tip the scales toward a more conservative expansion rate.

In theory, new franchisors should slowly expand outward in concentric circles, adding new franchises close enough to prior successful franchises that their advertising will reinforce each other, the franchisor's support costs are minimized, suppliers are available and knowledgeable concerning your requirements and give your franchisees priority service, etc. As a practical matter, however, many of the requests to buy franchises will come to the new small Texas franchisor from California, New York, Illinois, and other states where the franchisor may not be able to economically support isolated franchises or legally sell franchises. If it costs the franchisor $10,000 out of a $25,000 franchise fee to set a franchisee up in business, the franchisor makes a $15,000 profit. Popular variations are to make a large profit from building and equipping the location, selling a large initial inventory to the franchisee, etc. If the franchisee does poorly and his royalty payments less the cost of servicing him are negligible, the franchisor has to sell another franchise to cover his increased ongoing franchise support and servicing costs. Since remote franchisees will likely not pay enough in royalties to compensate the franchisor for their ongoing support, the result may be a Ponzi or endless pyramid franchise system dependent on selling more and more franchises each month to make the payroll needed to service current franchisees. Once begun, this process is often only halted by state franchise regulators or litigation from under-supported franchisees. The defect of selling remote franchises is not, however, always immediately apparent to the start-up franchisor, as the initial

franchise fee's impact on the bottom line can be an almost irresistible incentive to sell franchises to all comers.

A franchisor should be structured to be viable based on the money it receives from existing franchisees, company stores, initial capital, etc. Not building a large profit into initial franchise payments is the best way to avoid the otherwise irresistible lure of selling franchises to losers for immediate cash. Further, if the franchisee fee is low the franchisor has its pick of better franchisees. Better franchisees are more likely to succeed and pay royalties every year, year after year, and refer other wonderful prospective franchisees and are less likely to sue the franchisor than lose franchisees.

2. Under Capitalization

a. Problem. Revenue from current franchisees does not pay for their support, much less the legal and business cost of further franchise sales efforts. Since the typical start-up franchisor does not prospectively fully understand that franchising will require additional staff, substantial travel expenses, substantial legal expenses, etc., the start-up franchisor often looks at the initial franchise fee and continuing royalties as found money and starts franchising without a proper foundation of monetary, experience, operational staffing and legal compliance capital to support the effort. Unfortunately, the primary profit in franchising is from the steady stream of payments from happy, successful franchisees that have been in place for several years and no longer require much individual assistance. Until a franchise system has several such franchisees, its cash flow needs are dependent on the franchisor's company store profits or additional initial franchise fees. Since obtaining each additional initial franchise fee creates another mouth to feed a start-up (franchise to support), this is a problem.

b. Treatment. Some franchisors attempt to sell their way out of their financial bind by garnering more and more initial franchise fees. They hope to keep alive until the initial franchises begin paying sufficient royalties to finance the system. This is akin to racing a bullet—it rarely works and losing is fatal.

Alternatively, franchise expansion can be slowed to fill-in franchises which have a lower cost of servicing and will more quickly start sending substantial royalties. Costs will be cut by reducing remote franchise sales, travel expenses, services to the franchisees, and general belt tightening. An honest discussion with the franchisees concerning the franchisor's financial problem (often the last thing the franchisor wants to do) and appeasement through granting nonmonetary concessions may help the franchisees see the franchisor's cash flow shortage as everyone's common problem to be collectively solved rather than something to sue the franchisor over.

c. Prevention. Again, the best prevention method is to educate the start-up franchisor about the problem before the first franchise is sold. While the typical start-up franchisor cannot initially hire a chief financial officer with franchise experience, he or she may be able to buy the lunch of a non-competitive franchisor's CFO for a general educational discussion. The numerous books on this topic that are listed above can be made available to the franchisor.

3. <u>Cannot Sell Franchises to the Right Franchisees</u>

a. <u>Problem</u>. Your marketing costs, business and legal, are too high for the number of franchisees you are signing up. Further, the franchisees you want—young, hungry entrepreneurs with a little business experience—are either not responding to your marketing or are not willing to sign the franchise agreement. You are, instead, left with a few prospective franchisees who are fat, happy, dumb, and lazy and who are located outside of your areas of planned growth.

The typical causes of this problem are that the initial franchise fee is too high, the franchise is not being marketed effectively, the franchise contract is too oppressive, the concept is weak, current franchisees give the franchise system bad recommendations, the UFOC is not a good sales document, you cannot sell in the best states because the franchisor is not registered there, etc.

The deadly nature of this problem is not apparent on the front end. Whoever is in charge of selling franchises, whether a commissioned sales agent, business broker, or the franchisor's owner and chief executive officer is in fact able to make enough franchise sales to meet the system's sales goal for many months. It is not until much later that the realization slowly dawns that this was done by selling franchises to the wrong kind of franchisees, i.e., franchisees who will not work hard, who expect the franchisor to do all of the work for them, who will not succeed, are too far away to profitably service, give bad references to prospective franchisees, and may ultimately sue the franchisor. Common wisdom in the franchisor community, gained over several decades, is that the hungry franchisee willing to follow instructions, work like a dog, and inspire his or her workers to please customers is more likely to succeed in the long run than an individual with more money than motivation. The problem is not simply how to sell more franchises, but how to sell more franchises to <u>the right kind</u> of franchisees.

b. <u>Treatment</u>. The treatment for the problem is to look at your franchise system's franchise marketing from the point of view of the targeted young, hungry, motivated, prospective franchisee that the franchisor should want to sign up. The franchisor must remember that the target prospective franchisee has numerous other franchisors hawking franchises to him. Every aspect of your client's franchise offering needs to be gussied up, advertisements, initial franchise fees, UFOC, franchise agreement, etc., so that more target prospective franchisees will choose your client's system over its many competitor franchise systems.

A first item to look at is the initial franchise fee. If a lot of profit is built in to the initial franchise fee, then it is likely that other similar competitive franchises are being marketed to the target prospective franchisees for a lesser initial franchise fee. Since the target prospective franchisee has more motivation than money, this puts your client's offering at a severe disadvantage. It is usually in the long-term best interest of a franchise system to reduce the initial franchise fee to just cover all costs associated with getting a new franchisee started. This should increase the pool of wonderful prospective franchisees who will wish to sign up. If more wonderful prospective franchisees knock at the door, then your franchisor can choose the absolute best prospective franchisee in the region targeted for franchise expansion rather than having to accept a slug with money in some remote area. The long-term difference to the

system's profitability due to having the wonderful franchisee in the perfect city as opposed to the slug in a remote region is discussed above. The first franchisee will send substantial royalties and refer more wonderful prospective franchisees. The remote slug franchisee will cost more to service than he pays and ultimately send service of a lawsuit rather than royalties.

The UFOC and franchise agreement may not have been prepared to be useful marketing tools. They may have been prepared by a franchise attorney concerned solely with meeting the legal disclosure requirements and making the contract so thorough that the attorney cannot be later accused of neglecting to include any possibly oppressive contractual term in the franchise agreement that may later prove useful. Given a choice between your client's franchise documentation that is as inviting as an iron maiden and a competitor's more pleasing franchise documentation, the prospective franchisee will naturally choose the latter. While all legal disclosure requirements certainly need to be complied with, the franchise documentation can often be revised to highlight the advantages to the prospective franchisee of joining your client's franchise system. Further, after discussion and approval from the franchisor, some of the more oppressive language in the franchise documentation may be removed, modified, or made less prominent.

The inability to sell franchises at the desired rate can be a powerful wake-up call that the concept is weak and needs to be changed. This is not a matter that is lightly undertaken, since the franchisor's company stores and the initial franchises are already established doing whatever they are doing. Nevertheless, if target prospective franchisees do not see the concept as something they want to be part of, it may need to be altered. What are the competitors doing?

One of the most frustrating kisses of death to franchise marketing is bad recommendations given by the system's current franchisees. If current franchisees are giving your client's system bad recommendations to prospective franchisees because of the franchisor's under-capitalization, selling franchises to remote areas that cannot be properly serviced, selling to franchisees who were never going to succeed, etc., then it will be very difficult to sell new franchises. It is obvious that the franchisor will more likely sell franchises if its current franchisees sing the franchisor's praises to prospective franchisees instead of cursing the franchisor. The first steps toward this are to provide current franchisees with such a wonderful concept and great service that they make huge profits, only sell to franchisees who are going to succeed anyway, etc.

Additionally, the franchisor should remove any negative incentives and increase the positive incentives to current franchisees with respect to new franchisees entering the system. A current franchisee in City, U.S.A. may not want additional franchises in City, U.S.A. because it will split the market for its goods and services in City, U.S.A. The current franchisee has a negative incentive for new franchisees to enter the City, U.S.A. market. When prospective franchisees call, he discourages them from buying. The franchise system should be designed so that having more franchisees in the system increases the system's critical mass, makes the franchisor more able to provide advertising and services, will help the current franchisee advertise throughout its city by combining advertising dollars with additional franchisees, etc., all to the end that each current franchisee will likely have more money in his pocket down the line if more franchisees join the system. Each franchisee must have a large enough exclusive territory to make this discussion of benefits versus cannibalistic disadvantages truthful. The

franchisor may wish to formally or informally give rewards, monetary or otherwise, to franchisees that are responsible for new franchisees joining the system. (This can have its own legal complications if the new franchisee claims he was lied to by the referring franchisee.)

While it is true that there are only 17 states which require franchise registrations, a brief perusal of population and economic statistics shows that these states comprise much of the target market for franchises in the United States. Leads generated by national advertising for franchise sales will show a 40% to 50% response rate from registration states. Thus, while it is more economical for the start-up franchisor to not go to the expense of getting state franchise registrations everywhere, the detriment of having the effectiveness of national marketing reduced by about half takes a cumulative toll. The franchisor should target registration states for franchise registration in the order in which it plans to expand.

c. Prevention. The best method of preventing this problem is to start small and slow. One or more company stores should test, alter, and perfect the concept, operations manuals, etc. A small handful of franchises, perhaps as few as one or two, should be sold to the world's best prospective franchisees, put in an easy-to-service region, given the absolute best locations in town, and have franchisor service lavished on them. This process will inevitably result in further improvement and tweaking of the previously untested franchise support system. After the initial franchisees are successful and are singing the franchisor's praises to anyone who will listen, then the franchisor may begin general marketing of franchises. Now, the franchise salesman's most effective sales pitch is "But, don't listen to what I have to say. Call our franchisees to see what they think about our franchise system." Since the initial franchisees will gush with honest praise, the target prospective franchisees will want to sign up.

Further, as discussed above, the initial franchise fee should be set as low as possible while yet covering the full expense of getting a new franchisee started, franchise documentation should be prepared to please the target prospective franchisees, etc. The American Association of Franchises and Dealers is working on a model franchise agreement designed to deal with the legitimate concerns of both franchisors and franchisees. The International Franchise Association has promulgated a set of ethical principles. A franchisor's ability to give this set of principles to prospective franchisees and truthfully tell them that the franchisor abides by them may be a useful sales tool.

B. Franchise Sales – Legal Problems

1. Misrepresentations in Sales

a. Problem. Any or all of the franchisor's salespersons, UFOC, advertising, franchise agreement, etc., promised more than the franchisor could have and did deliver to one or more franchises. This fact is either discovered by your internal fact-finding investigation or after receiving service of the franchisee's, state franchise regulator's or FTC's complaint. FTC v. Kitco of Nevada, Inc., 612 F. Supp. 1282 (D. Minn. 1985) (defendant distributed brochures misrepresenting the business opportunity profitability).

Franchising or promotional claims do not need to be demonstrably false to violate Section 5 of the FTC Act. The person making such claims must have a reasonable factual basis

for making the claim at the time it is made. Jay Norris, Inc. v. FTC, 598 F.2d 1244 (2d Cir. 1979) cert denied, 444 U.S. 1980 (1979). Statements which are likely to mislead reasonable consumers are deemed "false." FTC v. Pantron I Corp., 33 F.3d 1088 (9th Cir. 1994) cert. denied, 115 S.Ct. 1794 (1995); Kraft, Inc. v. FTC, 970 F.2d 311 (7th Cir. 1992), cert. denied, 113 S.Ct. 1254 (1993); Hampton v. Sabin, 621 P.2 1202 (Ct. App.--Ore. 1980) (Rescission granted due to Franchisor's misrepresentation of the restaurant's past profitability). The franchisee may also assert that your franchisor should have disclosed other material information even if not required to be included in the UFOC. Williams v. Dresser Industries, Inc., Bus. Fran. Guide (CCH), part 10,726 (N.D. Ga. 1992) ($6 million in punitive damages awarded for nondisclosure of high minority dealer failure rate.)

b. Treatment. If the prospective franchisee shows your franchisor its business plan, loan repayment schedule, projections, etc., before the franchise agreement is signed, and induces your franchisor to utter some platitude about it appearing reasonable, etc., and the franchisee's plan fails, the franchisee may use your franchisor's statement as the basis for a fraud, misrepresentation, and negligence claim. Invacare Corp. v. Speer Corp., 612 F.Supp. 448 (N.D. Ohio 1984); High v. McLean Financial Corp., 659 F.Supp. 1561 (D.D.C. 1987).

No magic wand will make this problem go away. Although the details of the legal repercussions of misrepresentations in franchise sales are beyond the scope of this paper, generally, if proved, the franchisee may be able to obtain rescission, lost profits, damages, attorneys' fees, etc., the state franchise administrator may require state-wide rescission, civil and criminal penalties, withdraw permission to sell franchises in the state, and the Federal Trade Commission may obtain customer redress, injunctive relief, and $10,000 a day fines. All of these remedies may be imposed against the franchisor and possibly against any individual person who made, participated, and/or authorized the misrepresentations. In addition to the other papers in this Franchise Program a comprehensive article on this issue which should be looked at are Kim A. Lambert and Charles S. Modell, Learning to Swim: Avoid the Undertow – Presale Violations, Rescission, Remedies and Damage Control, Annual Forum of the American Bar Association Forum Committee on Franchising (1995).

As a beginning point, you should review the tool box of legal alternatives discussed above. A commonly attempted balm is for the franchisor to keep dancing while waiting for the expiration of the statute of limitations, and the onset of waiver, ratification, equitable estoppel, etc. to create effective legal defenses while making every extra possible effort to provide sufficient additional services to the aggrieved franchisees. This may avoid having to pay you many tens of thousands of dollars to deal with private litigation or state franchise administrator ordered or statewide rescission of FTC actions.

Circumstances which may pre-empt this delay strategy are the requirements of different registration states to offer rescission to franchisees who did not receive effective disclosures, the problem of making proper disclosures to new prospective franchisees and the fact that some statutes of limitation, acts of ratification, etc., may not be effective until the franchisees have learned of the misrepresentation. Applicable state franchise laws may require that a formal disclosure of the misrepresentation and a full offer of rescission be made to that state's franchisees on pain of personal civil and criminal liability for all persons who are aware of the misrepresentation and failed to report it to the state franchise administrator. The state franchise

administrator may require a formal offer of rescission to all of the states' franchisees. To get applicable statutes of limitation and defenses such as ratification running, you may wish to do this anyway.

The systematic nature of a franchise system means that misrepresentations made to any franchisee may have been made to many franchisees. Still further, these representations may be still being made in the franchisor's ongoing sales. These factors make dealing with franchise sales misrepresentations a cause of migraines and ulcers.

Concerning new sales, regardless of practical problems caused by telling the truth to new prospective franchisees, your position as attorney absolutely requires you to insist on a full and accurate disclosure. While you have some leeway in coming up with strategies to deal with past misrepresentations within the bounds of lawful ethical representation, you may not permit any misrepresentations to be made in new sales. This may require an amendment to the UFOC which will require the amended UFOC to be filed in registration states. This will alert the state franchise administrator to the misrepresentation previously made to franchisees in that state and may cause the state franchise administrator to begin action against your franchisor.

If anyone develops a satisfactory answer to this dilemma, he or she is encouraged to share it with this paper's author.

c. Prevention. The single best prevention method is to educate everyone concerning the **personal liability of everyone and anyone who permits or makes a misrepresentation in the franchise sales process.** The franchisor's principals should be counseled concerning the fact that any franchisee's misrepresentation suit will likely include them as individual defendants. A frank discussion should be had concerning the horrendous cost of even victorious litigation together with the fact that the wonderful franchise documentation you have prepared does not guarantee victory in the courtroom against misrepresentation allegations. Everyone in the franchisor's organization needs to understand that losing half a dozen franchisee sales is much more preferable than being sued by one disgruntled franchisee two years down the line – even if the franchisor wins.

One method of emphasizing the personal responsibility of each individual and to decrease the likelihood of misrepresentations is to prepare a detailed check-off list describing each necessary contact, disclosure, registration, etc. for any franchise sale and requiring that some individual, warm, living human being separately date and sign each of the listed steps accomplished by that human being. This helps ensure that each person who talks to the prospective franchisee, makes the offer, makes the disclosures, signs the franchise agreement (after the ten business day waiting period), etc is aware that they are personally responsible for their act being in compliance with all applicable laws. While this is somewhat of a bureaucratic, Chinese fire drill, it is cheap relative to the cost of one disgruntled franchisee lawsuit.

Most small franchisors attempt to firewall out these possible liabilities by creating a separate franchisor sales corporation. This is recommended but everyone should understand that this does not necessarily avoid personal liability or piercing of the franchisor corporation's corporate veil. This is particularly true due to the mixing of personnel, facilities, supplies, etc.,

between the franchise and company store support operations. The franchisor should be asked to put you on all mailing lists and send you copies of all advertising before it goes out to anyone.

2. **Failure to Comply with Franchise Sale Laws**

a. Problem. Your franchisor receives a letter from a state regulator demanding statewide rescission or a letter or suit from one or more franchisees demanding rescission and damages due to your franchisor's failure to comply with the applicable state franchise law. Upon reviewing the facts, you find that damages or rescission is, in fact, required under the applicable state law due to your franchisor's failure to timely register, failure to make timely adequate disclosures, etc. Hicks v. United Snack Group, Inc., Bus. Fran. Guide (CCH), part 10,131 (W.D. Wash. 1992). (Failure to comply with franchise law may give franchisees the right to rescind or obtain enhanced damages.) My Pie, Int'l v. Debould, Inc., 687 F.2d 919 (1982) (franchisee's purchase of employee tee-shirts from franchisor within seven days of receiving UFOC, i.e., not waiting ten days, justified rescission.)

b. Treatment. The first step in dealing with state regulators is to appreciate that they have more to do than they can possibly get done. If the regulator believes your franchisor made an inadvertent error and is now taking all necessary steps to quickly get the matter resolved, you may get some cooperation at the margins. If the regulator perceives that you and the franchisor willfully violated his or her regulations or have not yet gotten the message or are making the regulator's job unnecessarily more difficult, then the regulator will classify your franchisor as a bad actor and react accordingly. Because of this very human reaction, it is important to promptly respond to the regulator in a truthful and cooperative manner with a solution to the problem. While this should not be a point that needs making, regulators advise that attorneys, as a class, have not yet gotten this message.

If rescission or a finding of unlawful conduct is not required under the facts of your case, you should certainly persuasively make that argument to the regulator. The regulator's allegations of wrongdoing and suggested punishment are not written on stone tables from Mount Sinai. Regulators do, however, have a natural tendency to initially believe the franchisee's complaints. If the allegations are unwarranted, they should be refuted with massive overkill of supporting evidence. Assuming, however, for discussion purposes, that your franchisor client did in fact sell franchises in the state without a proper registration, etc., and that rescission is required, the next step is to try to get ahead of the problem by offering the affected franchisees as many emotional, monetary, and non-monetary inducements to not accept the rescission offer. Depending upon how valuable the franchisor's trademark and continuing services are to the franchisees relative to their payments to the franchisor, their loyalty to the franchisor, etc., none or all of the franchisees may accept the rescission offer.

You must thoroughly know the state's rescission requirements. For example, Illinois generally requires that the offer be written and delivered or sent by certified mail; that it include an offer to return the full consideration or repurchase the franchise for the price paid, less any net income received by the franchisee plus interest; can require unsold goods, equipment, and fixtures be returned; the offer must stay open for at least 30 days and it must apprise the franchisee of all of its rights. A sample letter is attached as Appendix "A." If a rescission offer is accepted, all monies paid from the franchisee to the franchisor must presumptively be returned

to the franchisee, subject only to those deductions that are permitted the franchisor under applicable state law. The amount of money that can be required by a rescission can be so staggering as to be fatal to the franchise system if many franchisees elect rescission.

Another preventive issue is to periodically discuss with all franchisor personnel whether there have been any adverse material changes lately. If so, the UFOC should be amended and the amendments filed in the registration states without waiting for the annual amendment process.

c. Prevention. As discussed above, the key to prevention is education of the franchisor concerning the horrific consequences of offering or selling franchises in registration states without an effective franchise registration there or in noncompliance with any applicable franchise law. The franchise sales check-off list should include a step where an individual human being verifies that the offer is being made to a prospective franchisee that is in a state into which the franchisor can lawfully sell and that the franchise is to be established in a state where the franchisor can lawfully sell etc. Copies of franchisee ads, ad placements, negotiation lists, offer lists, and sale lists should be routinely forwarded by the franchisor's staff to you as a routine clerical matter so you can provide a backup check to ensure that no offers or sales of franchises are made into states where the franchisor is not yet registered.

In dealing with existing franchises, you must be aware of the applicable state's franchise relationship laws, if any. The substance of these laws is beyond the scope of this paper. Pitegoff, Franchise Relationship Laws: A Minefield for Franchisors, 45 The Business Lawyer, 289 (Nov. 1989). These laws legislate certain most favored nation clauses, Canada Dry v. Nehi Beverage Co., Inc. of Indianapolis, 723 F.2d 512 (7th Cir. 1983), regulate the "good cause" reasons a franchisee can be terminated or not renewed, the notice is required to effect a termination, the effective of termination, etc.

3. Failure to Disclose Adverse Information

a. Problem. Several franchisees purchased their franchises in reliance on nondisclosure of adverse material information in the UFOC.

b. Treatment. This is a slight variation of the above nondisclosure problems. Get the facts, evaluate each applicable state's laws concerning whether the state franchise administrator must be notified, each statute of limitations, etc. Is the omission so material that you must stop offering franchises until the UFOC is amended? Can you cause an enforceable ratification, permit a transfer, and buy a release? As noted above, registration states have strict requirements concerning rescission offers.

c. Prevention. In your preparation of the franchise offering circular, each UFOC Item should be used as an opportunity to interrogate the franchisor about any facts that could possibly be used in future litigation to put him in a bad light. If relevant, these facts should be disclosed in the UFOC unless the state administrator orders it out (also safe harbor).

Disclosure of embarrassing details in the UFOC almost never prevents a sale. People buy a franchise because they like its look and feel and believe they can make money with it. Disclosure does, however, help bullet-proof the franchisor against nondisclosure causes of

action. Explaining the UFOC as a weapon against future rebellious franchisees encourages the franchisor to make full disclosure. If disclosure does prevent a sale, that is the best evidence that the sale should not have occurred.

You should periodically inquire of any new adverse developments during the year and insure that these developments are provably communicated to prospective franchisees rather than waiting for the annual UFOC rescission required by registration states. The UFOC may need to be amended and the amendment filed with the states.

4. Impound Imposed

a. Problem. A state franchise administrator, upon reviewing your client's weak financial statement, high initial franchisee fee, large number of franchises your franchisor estimates it will sell, and the large amount of support the franchisor is promising, decides that franchisees in the administrator's state need a guarantee that the franchisor's promised support will actually be delivered. To ensure this, the regular imposes an impound. An impound requires that all initial monies to be paid from the franchisee to the franchisor instead go to an escrow account until the state franchise administrator's conditions for releasing the funds to the franchisor are met.

As a practice matter, since the regulator only imposes an impound if the franchisor is undercapitalized, and since an undercapitalized franchisor cannot afford to deliver start-up services to a franchisee without first being paid the initial franchise fee -- much less pay the legal and administrative costs of setting up an escrow account for the impounded funds -- the requirement of an impound effectively prevents the sale of your client's franchises into the subject state.

Further, once any state has imposed an impound, this fact must be reported in franchise applications to other registration states. This is akin to going in with a target painted on your chest. This piling on of impounds by other state administrators may keep your franchisor from selling in any registration states until its balance sheet is cleared up.

b. Treatment. Once the letter is received from the state franchise administrator imposing the impound, your alternatives are limited. The best alternative, if available, is for the franchisor to have another entity provide a written guarantee acceptable to the state franchise administrator of the franchisor's performance of its duties to the franchisees to be sold in the subject state. Since most franchisors begin franchising by first incorporating a separate franchising company, most franchisors still retain their company stores in their original corporation. If the company stores have sufficient tangible assets, profitability etc., giving the state's franchisees a guarantee of the franchisor's initial performance may avoid an impound.

A less useful alternative is to amend your franchise agreement for that state to not require payment of the initial franchisee fee until after training is complete and the store is open. Title 10, Cal. Code of Regs. §31113 and Rule 310.113 ("The franchisor can stipulate that all franchise fees will be due and payable only after it has fulfilled and performed all of its initial obligations to the franchisee").

Given that your franchisor is undercapitalized, once the state franchise administrator imposes an impound, the alternative of selling franchisees pursuant to the impound condition is even less workable in practice than it sounds in theory. The legal and administrative expenses, hassles, and delays in getting everything set up are high, partly because so few escrow accounts are actually set up for impounds, that no one knows what to do. Everyone participating in the sales process will know of the impound and that any complaint by the franchisee of lack of support will likely block the franchisor's efforts to get at the escrowed fees. Imposition of an impound gives everyone the impression that the franchisor is not financially stable and may make the franchises unsalable in any event. In practice, therefore, imposition of an impound prevents the sale of franchises in the subject state.

c. **Prevention**. The same boring advice is applicable to this problem. A start-up franchisor who slowly and steadily expands outward from its Texas home base will not reach a registration state where an impound can be imposed until after the franchisor has achieved a critical mass of franchisees, thus, making expansion into any particular registration state only a minor imposition on the franchisor's ability to provide support. Further, the franchisor's mature, profitable franchisees by then will provide the franchisor with a solid enough financial statement that the state franchise administrator will believe the franchisor can likely satisfy its obligation to initially service franchisees sold in the subject state.

As a rough rule of thumb, the excess of current assets over current liabilities on the franchisor's books should be sufficient to fund all pre-opening services the franchisor will be obligated to provide to its franchisees in the subject state during the coming year without recourse to the fees expected to be paid by the franchisees. Thus, when registering a UFOC, you should reign in the franchisor's wildly optimistic projections of franchise sales. A California administrator is more likely to impose an impound upon a small franchisor who states in UFOC Item 20 that the franchisor intends to sell 40 franchises in California next year than on a small franchisor who discloses that it intends to sell four franchises in California next year.

5. **Franchisee's Costs Exceed UFOC Estimate**.

a. **Problem**. The franchisor disclosed reasonable estimates of opening costs, inventory costs, location costs, etc. in the UFOC Item 7, Initial Investment disclosure. Since a reasonable estimate is a projected average over many franchisees and any average has some items above the average, some franchisees will necessarily spend more to open their unit than the Item 7 disclosure estimates. Sure enough, the franchisees who ran up initial expenses exceeding some of the categories of expenses disclosed in Item 7 are either complaining or already have sued the franchisor claiming misdisclosure.

b. **Treatment**. This is another sales misrepresentation issue, to be handled as discussed above.

c. **Prevention**. The franchisor is understandably reluctant to include excessively high cost estimates in its UFOC Item 7 Initial Investment disclosure because prospective franchisees then will buy from the competitive franchisor selling Brand X practically-no-cost-to-open franchises. On the other hand, any reasonable estimate of initial costs will, by definition, be exceeded by some franchisees leading to possible litigation by

franchisees claiming that they were lied to, a prevention method is to include in the UFOC Item 7, Initial Investment disclosure of initial costs, a lower and upper range of expenses that a new franchisee might encounter as initial costs for each item. The upper range for each category of estimated expenses should be well above what any franchisee could incur. The lower range estimates can be more in keeping with the realistic average franchisee costs. When prospective franchisees compare the high-low estimated expenses together with their probable individual actual requirements as explained in the several Item 7 footnote explanations, they will be able to use the Item 7 disclosures to help estimate what their particular cost to open a franchised unit in City, U.S.A. The estimates that the prospective franchisee himself makes using this information will be lower than any average estimate the franchisor could provide. This results in a meaningful disclosure to the prospective franchisee that helps sell franchises without setting the franchisor up for misdisclosure litigation.

> Earnings claim means information given to a prospective franchisee by, on behalf of, or at the direction of the franchisor or its agent, from which a specific level or range of actual or potential sales, costs, income, or profit from franchised or non-franchised units may be easily ascertained. (UFOC Item 19, Instruction (1)).

6. Franchisee's Income is Less Than Represented

a. Problem. The franchisee produces credible evidence that the franchisor or the franchisor's salesman, broker, etc., made misrepresentations concerning what the franchisee's income would likely be. The income projection may have been based on more mature profitable stores in the franchise system, on stores that have better circumstances than the franchisee's store, on the supposedly wonderful location the franchisee store was going to be in, etc. The income projection may be written on the proverbial airport bar napkin or made verbally to the prospective franchisee. However the income representation was formulated or communicated, on the facts of your case, the representation was made, is not being met, and it looks like your franchisor is stuck with it.

b. Treatment. After the fact, this is just another sales misrepresentation issue, to be handled as discussed above.

c. Prevention. Since every franchisee purchases the franchise believing, for some reason and on some evidence, that he is going to make money, it is clear that the franchisee is going to get some information from somewhere concerning likely profitability before buying a franchise from your franchisor. The only questions are what the information will be and where it will come from.

One common approach used by small franchisors is to:

(1) include in the UFOC Item 19, Earnings Claims disclosure, the following or similar language:

> REPRESENTATIONS REGARDING EARNINGS CAPABILITIES. Franchisor does not furnish or authorize its sales persons to furnish any oral or written information concerning the actual or potential sales, costs, income, or profits of a franchisor restaurant. Actual results vary from unit to unit and franchisor cannot

estimate the results of any particular franchise. **(UFOC recommended Item 19 negative Disclosure.)**

(2) warn all franchisor personnel against releasing any data that a franchisee might be able to use to calculate estimated profitability, and

(3) encourage the prospective franchisee to call the franchisor's current franchisees to obtain whatever information he desires from them to answer probable profitability questions.

On the plus side, this may legally distance the franchisor from representations made by the current franchisees. Ideally, the current franchisees will tell the prospective franchisee that they are very profitable, the prospective franchisee will buy, and, if the new franchisee's unit is not ultimately profitable, the franchisor will not be liable for having misrepresented profitability. On the negative side, depending on how concerted the action is between the franchisor and the current franchisees in their giving profit data to the prospective franchisee, (bonuses to referring franchisees, etc.) the franchisor may be legally stuck with whatever uncontrolled projections the current franchisees made. Further, since the prospective franchisee is ravenous for estimated profitability data and the franchisor's sales person wants to make the sale so he can use the franchise sales commission to meet his past-due home mortgage payment, the franchisor sales person will be motivated to give some profitability data regardless of the franchisor's written instructions. What such a franchisor sales person says will not be controlled and the franchisor legally may be stuck with it also. Finally, the franchisor's competitors, other franchisors seeking to sell a franchise to the target prospective franchisee, do provide projected profitability information to the prospective franchisee. The target prospective franchisee and his investors will be more comfortable with data a franchisor will stand behind and buy a franchise from the competitor franchisor instead of your franchisor.

Because of these above several problems, large franchisors typically elect to provide some information concerning projected profitability in their UFOC Item 19 disclosure and to then surround it with bold, capped, large-print, underlined disclaimers and qualifications. The prospective franchisee will likely only use the data provided and ignore all of the lawyer's bolded, all-capped, and underlined disclaimers and qualifications. This has the benefits of being a controlled release of data that the franchisor knows he can defend and of helping the franchisor's franchise salesman make more sales to better prospective franchisees out on the front lines.

(1) A reasonable basis exists to support the accuracy of the claim

(2) The franchisor must have sufficient material in his possession at the time an earnings claim is made to substantiate the claim. FTC v. Independent Travel Agencies of America Assn., Bus. Fran. Guide (CCH), part 10,615 (S.D. Fla. 1995) (FTC alleges franchisor's earnings claims were unlawful where they failed to disclose the substantiating information), and

(3) Except for claims made in the media, an earnings claim must be geographically relevant to the prospective franchisee's proposed location. The UFOC Item 19 Earnings Claims disclosure was recently amended to permit franchisors to make limited earnings claims as long as they have "a reasonable basis for its earnings claim." The Item 19 instructions further state that the factual basis of an earnings claim includes significant matters upon which a franchisee's future results are expected to depend. This includes, for example, economic or market conditions which are basic to a franchisee's operations and encompass matters affecting, among other things, franchisee sales, the cost of goods or services sold, and operating expenses. In the absence of an adequate operating experience of its own, a franchisor may base an earnings claim upon the results of operations of a substantially similar business of a person affiliated with the franchisor or franchisees of that person; provided that disclosure is made of any material differences, and the economic or market conditions known to, or reasonably ascertainable by, the franchisor. [Emphasis added.] Further, under the UFOC, any earnings claim must state its (a) material assumptions, (b) a statement of whether the claim is based on actual experience of franchised units, etc., (c) "a conspicuous admonition that a new franchisee's individual financial results are likely to differ from the results stated in the earnings claim"; and (d) a statement that substantiating information will be provided on request. It is reasonably clear that these requirements will not be satisfied on the proverbial airport bar napkin.

C. System Changes

1. Bad Concept.

a. Problem. Zag Ziglar could not sell the franchise system's core concept, i.e., pickles and ice cream dishes. Alternatively, the concept originally worked well at the franchisor's company stores and initial franchises but does not work well enough now relative to competitive chains in the changing marketplace. Retail sales at franchisee stores are leveling out or declining.

b. Treatment. Unfortunately, the response of some franchisors is to emphasize and refine the bad concept and die. While this is not the alternative recommended by Harvard Business School it is a popular choice.

The other alternative is to change. This is hard. Far from the smallest impediment is the attachment of franchisor's management to the way the franchisor successfully expanded, first from a single store into a successful chain of stores, and then into a successful franchise system. The problem should be approached from the point of view that the original concept was indeed wonderful and innovative but that changed market conditions, tastes, supplies, a more competitive environment etc., require changes if the business is to survive. If the world's most efficient, practical, cheapest, safest, most environmentally wonderful product is no longer what The Great American Public is willing to part with money for and if, for example, The Great American Public will pay money for fatty, high-cholesterol, death-inducing products, then the system must sell the latter or perish.

The next step is to figure out what changes need to be implemented. While this may not be rocket science, it is painful. Successful competitors need to be studied. The franchisor should consult with marketing experts. Alternative new concepts should be tried out in test markets. It

is important to bring the franchisees along during the entire process rather than conducting it secret and announcing the changes to the franchisees. Not only may the franchisees have valuable input but their cooperation (and, hopefully, enthusiasm) is necessary to make even the best concept work. Their cooperation will not be obtained unless they emotionally feel that they have helped to develop the new concept. The franchisor must sell the new concept to the franchisees rather than impose it as permitted by the franchise agreement. The best way to do this is to not sell it but let the franchisees themselves participate in and help develop the changes. No one has a greater stake in the changes being successful than the franchisees.

Before imposing any new requirements, your franchisor's franchise agreements need to be checked to ensure that the franchisor has the power to enforce concept changes. Even if the franchise agreements give the franchisor the power to immediately enforce concept changes, it is often wiser to not enforce major concept changes on an unwilling franchisee until the franchise comes up for renewal. The franchisor has much stronger legal weapons at the time of renewal. Just as importantly, most franchisees feel that the franchisor is entitled to require major changes at renewal.

c. **Prevention**. No one knows for certain ahead of time whether a concept will or not induce The Great American Public to fork over money and to continue to infinitely do so. Since so much is at stake, you should encourage the franchisor to improve the odds by continually discussing his concept with industry experts, doing demographic studies, speaking with marketing experts, personally doing token business at competitors' stores to see what they do, subscribing to industry publications, joining and attending industry associations, etc. Basically, the more information the franchisor gathers, the more likely the franchisor's choices for the initial concept and concept changes will be on target.

Once franchise units are established, the franchisees and their retail customers will invariably cause small variations of the concept to occur at their different locations. On the one hand, letting franchisees repeat the mistakes the franchisor made in arriving at the franchise system's methods is counterproductive and is contrary to the whole basis of franchising. On the other hand, your franchisor may give certain franchisees limited variances for limited periods of time for experiments because, if the variances on the original concept are successful, they should be adopted rather than treated as heresy.

2. Bad Execution of the Concept

a. **Problem**. Although The Great American Public is buying some of the franchisee's units' goods and services, it is not buying enough to justify the expensive build out currently required of the franchisees by the franchisor. The franchised concept will work if the franchisor reduces the unneeded equipment and built out expenses by 60 percent. That 60 percent extra investment does not produce enough extra profit. What do we tell our current debt-laden franchisees who got in over their heads in reliance on what the franchisor now realizes was bad execution of its concept?

b. **Treatment**. "The first rule of getting out of a hole -- 'stop digging'" is, once again, applicable. Regardless of the embarrassment and any other consequences, pushing the old concept must be immediately stopped and the new workable

concept implemented. The franchisor should never push anything but the concept and requirements that the franchisor now honestly believes is the best. Continuing to require the old concept sets the franchisor up for franchisee fraud and willful misrepresentation suits.

Concerning current franchisees stuck with an unusable investment in the old concept, the above tool box of legal alternatives should be reviewed. If they are profitable, perhaps nothing needs to be done except to encourage and permit them to change over to the new concept. If they are not profitable, everything possible should be done to delay and avoid litigation brought by franchisees alleging breach of the franchisor's representations and duty of competence. This may include giving rights of refusal to adjacent areas, some royalty payment relief, additional advertising assistance, etc. Delay of litigation is an end in itself, as delay may bring relief via ratification, waiver, statute of limitations, etc.

c. Prevention. The best preventative against radical changes to the concepts is for the franchisor to test market everything on prior franchisees, to be continually open to new changes and to continually implement minor changes as the market and competitive environment requires. While this minimizes the changes required at any given time, this platitude must also be balanced against the many forces compelling franchise system uniformity, i.e., need to create and maintain a single customer perception of the franchise chain, need to avoid letting franchises repeat the same experimental mistakes, need to be able to provide uniform support to all franchisees, etc.

The franchise agreement should be written to give the franchisor limited authority to require concept changes during the term of the franchise and vast powers to require concept changes at the time of renewal.

3. Franchise Agreement Not Applicable to New Conditions

a. Problem. The planning, demographics, and concept were great. Unfortunately, The Great American Public refuses to leave enough money at the franchisees' stores. Half of the concept needs to be thrown out, new goods and services added to the franchise system, point of purchase computer information retrieval systems need to be added, the franchisee's bank accounts should be electronically debited to obtain prompt royalty payments, etc. Unfortunately, the short franchise agreement (the franchisor insisted on a short one) locks everyone into the old concept and does not permit the franchisor to force the franchisees to make changes in their stores and their goods and services.

b. Treatment. The current franchisees have as much of a stake in the franchise system being successful as the franchisor. An open discussion of the problem and all possible solutions, including the franchisor's proposed concept changes, may obtain the agreement of most of the franchisees to the changes. The franchisees may have some good ideas. Inducements may have to be offered to get the franchisees to change over to a new agreement. For franchisees that refuse to change regardless, a deal is a deal. The stubborn franchisees can stand on their franchise agreement until renewal or expiration of their franchise. As the stubborn franchisees approach franchise renewal or expiration, great pressure can be brought to bear on by advising that the franchise will not be renewed unless the franchisee signs a new franchise agreement and makes the requested changes now. Digital Equip. Corp. v. Uniq

Digital Technologies, Inc., _____ F.2d _____, Bus. Fran. Guide (CCH), part 10,824 (7th Cir. 1996).

c. **Prevention**. Anticipation of this problem will help you prevent it by including terms in the franchise agreement giving the franchisor the right to require substantial changes. The franchisor's power to require substantial changes cannot be too substantial, however, without making the franchise agreement unsalable.

More generally, the franchise agreement you prepare provides the formal structure or skeleton for the franchise system. You must take into account the special circumstances and expectations of your new franchisor in drafting the franchise agreement. Merely copying a competitor's franchise agreement or a form book franchise agreement will cause long-term problems. The first place to begin is probably an unstructured visit to the client's business, review of his current business forms and procedures, talks with his managers, etc. The more you understand about the client's business, the more intelligently you can structure the franchise system.

As most franchise programs depend on royalties and franchisee reports about what is working and what is not, detailed terms concerning franchisee payments and reporting are paramount. The franchise agreement should require frequent payments and reports (so franchisees will have less motivation at each report to cheat and have less of an opportunity to cook the books), permit random audits, secret shoppers, etc. While minute operational details should be left out of the franchise agreement to be implemented in the Operations Manual, "as the same may be revised from time to time," any franchisee duties and payments which are likely to be disputed later should be detailed in the agreement itself. On the other hand, over-controlling the franchisee in the franchise agreement harms franchise salability, lessens the franchisor's ability to change operational details in the Operations Manual and may make the franchisor vicariously liable for franchisee's acts as discussed below.

If at all possible, get the client to actually read the entire final agreement in your presence at a time and place when his attention can be focused on it. This final reading will take some hours and will always reveal a few embarrassing inconsistencies between his expectations and your document. The franchisor needs to have read the full document because he will run the franchise system day in and day out for years without you at his elbow. Further, this final thorough read through followed up by your letter including the final agreement helps make the franchise agreement the franchisor's document as well as yours when something is found to have been left out or misstated five years down the road.

D. Franchisor Non-Performance

1. Failure to Provide Promised Support

a. **Problem**. The franchisees credibly complain that their promised and needed support from the franchisor never arrived. What support they have received has not been very helpful. They see the independent competitor across the street charging lower prices and see the franchised competitor at the end of the block receiving competent franchisor support in the form of better quality goods delivered at quantity discount prices, regional and national

advertising support, assistance in training key staff persons, etc. Meanwhile, your franchisees are getting ulcers and migraines because The Great American Public is not leaving enough money at their franchise unit to make payroll. When confronted with the need to either peacefully write off their investment, peacefully blame themselves, or blame the franchisor and sue it, the choice will be easy. They are about to close their doors and sue.

b. Treatment. The whole range of the above toolbox of legal alternatives should be reviewed because the franchisees may feel that they have no practical option except to sue. On the ground, all possible efforts should be made to get competent support to the franchisees since litigation costs more than support.

c. Prevention. The franchisor will only succeed if the goods and services it provides the franchisees are so valuable that its franchisees are more successful than they would be without the franchisor on their backs. The system is doomed if all that holds the franchisees is the cage of your harsh franchise agreement. The franchisor should provide such valuable start-up services for the money that good prospective franchisees will want to pay a reasonable franchisee fee to obtain them. The franchisor should provide such valuable continuing services to the franchisees thereafter that they want to pay their royalties, follow policy, and refer potential franchisees because they are happy, satisfied customers of the franchise system. To make these platitudes real, the franchisor must both write sufficient checks to permit staffing up on franchise support personnel and indoctrinate everyone in the franchise company that making the franchisees profitable is their number one goal.

The franchisees are the franchisor's paying customers who the franchisor should bend over backwards to keep happy. Your masterful franchise agreement cannot make the franchisor money in the long run if too many franchisor/ franchisee relationships sour. The best investment a franchisor can make is a continuous effort to, at a minimum, keep good relations with each franchisee and, at an optimum, create franchisee loyalty. First month and first year franchisees should have frequent visits. All franchisees should be frequently visited and telephoned. Time spent hand-holding, being visibly concerned and delivering small favors and aid is one of the franchisor's best investments.

The reason McDonald's succeeds is that it concentrates primarily on making its franchisees successful rather than trying to make a profit selling them equipment, goods and services. (A useful method of making this point is to give clients *McDonald's: Behind the Arches*, by John Love (1986), and reference them to pages 64-67. Because new franchisors look to McDonald's with reverence, the war story told on those pages will do more to get this point across than any amount of preaching).

Legally, you want the franchisor to have sufficient procedures and forms to properly document the many services, visits, telephone calls, and other assistance to the franchise for possible use as litigation evidence of your franchisor's support. These backup documents should guide the franchisee and the franchisor's personnel into continuously creating good evidence of the franchisor's on-going competent support.

Non-Performing Subfranchisor

d. Problem. The services the franchisor owes the franchisees are to be delivered by a subfranchisor and the subfranchisor is not delivering. This is a nightmarish problem since the franchisees will not prosper if they do not receive services and they must prosper if the franchise system is to succeed. More immediately horrible, if the franchisees fail, they will sue your franchisor who may be liable for the failures of the subfranchisor.

e. Treatment. The franchisor may (1) cut a new deal with a subfranchisor to take over the subfranchisor's duties in exchange for reducing payments to the subfranchisor, (2) sue the subfranchisor for the subfranchisor's failure to provide the promised support, (NOVUS Du Quebec, Inc. v. NOVUS Franchising, Inc., Bus. Fran. Guide (CCH), part 10,8230 (D.C. Minn. 1996) (subfranchisor terminated), (3) provide the promised support to the franchisees without sufficient compensation until the subfranchisor's agreement expires, or (4) provide the promised support to the franchisees and deduct from the subfranchisor's compensation the cost of providing those services leaving the franchisor/ subfranchisor battle until later. The latter alternative is only possible if the franchisee's payments are being made directly to the franchisor rather than to the subfranchisor.

f. Prevention. First, the fact that none of the above alternatives are attractive helps illustrate why the author is prejudiced against subfranchising (defined as turning a territory over to an entity which, under the franchisor's trademark, will itself sell and service franchises with little support from the franchisor) except in compelling circumstances due to the intractable nature of the difficulty caused if the subfranchisor does not properly perform. Second, if a subfranchisor relationship is necessary, then the franchisor's agreement with the subfranchisor should contain specific quantifiable measures of performance and the franchisee's agreement should state the franchisee agrees that duties delegated to the subfranchisor are delegated without recourse to the franchisor. Franchisee payments should be paid directly to the franchisor, with the subfranchisor's compensation to be paid from the franchisor rather than directly from the franchisees and made expressly contingent on the subfranchisor performing. In the event of a problem between the franchisor and the subfranchisor, this control of funds may be critical in obtaining a favorable resolution.

Alternatively, the subfranchise agreement can be written so that it is a subfranchise agreement in name only, to-wit, the subfranchisee's function can be made to be more akin to that of a broker, its sole responsibility being to bring prospective franchisees in the region to the franchisor, the franchisor decides whether or not to sell to the specific franchises, and the franchisor is directly responsible for servicing them. This all must be disclosed in the UFOC. True subfranchisors must register their own UFOCs with the relevant states.

The above negative comments about subfranchising in the United States do not apply to what is called master franchising in foreign countries. International franchising has such substantially different conditions that master franchising is the preferable method of international franchising.

2. **Unusable Trademark**

a. **Problem**. Your franchisor gets a letter including an incontestable federal trademark registration 15 U.S.C. §§115(a) and (b) from a remote competitive business stating that your franchisor's principal trademark is infringing the competitor's trademark rights and the competitor is expanding into your franchisor's territory. Upon investigation, you determine that the competitor's federal registration issued before your franchisor began business and your franchisor's trademark position is indefensible. Your franchisor's UFOC Item 13, Trademarks disclosure, did not disclose this problem.

b. **Treatment**. In common with all sales disclosure issues, no further franchisees can be sold without this adverse material fact being disclosed in the UFOC. As a practical matter, this will prevent further franchises being sold under the franchise system's current trademark unless this problem is solved.

If the franchise system has not previously retained a trademark lawyer, one should be immediately obtained. Hopefully, a thorough investigation of the facts will either show that (1) your franchisor is the senior user and the competitor's federal trademark registration is not yet incontestable, so your franchisor can cancel it; (2) your franchisor began its use of the trademark prior to the competitor filing for its incontestable federal registration so your franchisor at least has some trade areas to fall back on; (3) perhaps pre-existing users of the mark can be found and possibly be used as the basis for canceling the competitor's trademark registration or possibly you can obtain a trademark license from them; or (4) perhaps the competitor's trademark rights are so narrow that your franchisor's use does not infringe them. A detailed discussion of the availability and methods of launching these counter-attacks is beyond the scope of this paper.

Assuming that none of the above discussed counter-attacks are available, the fact situation described above means that the competitor has a legal right to obtain injunctions against each of your franchisees' use of your franchise system's trademark as the competitor moves into each of your franchisees' trade areas.

Your franchisor's franchise agreements hopefully require franchisees to change trademarks upon the franchisor's demand. Enforcing this franchise term under the circumstances will create a great deal of unpleasantness due to the franchisee's reliance on the franchisor's apparently defective UFOC Item 13 Trademarks disclosure in the franchise sales process. Restated, the franchisee will assert that it would not have purchased the franchise had the franchisor properly disclosed the existence of the competitor's incontestable federal trademark registration.

This throws the franchisor back to the toolbox of legal alternatives discussed above. It is unlikely that the competitor with the prior incontestable federal trademark registration will be immediately entering all of your franchise system's trade areas at once. The franchisor may wish to get the above discussed statute of limitations, ratifications, waiver, etc., clocks running by immediately disclosing the bad news to all franchisees. Perhaps most of the franchisees will not be adversely affected immediately or possibly even for the duration of their franchise agreement. In the meantime, a new trademark can be developed with the input of and consultation with the franchisees so that they will be less unhappy about changing over to the new, wonderful

trademark they selected over a period of years than they would be if the franchisor sends a letter citing a clause buried in the franchise agreement and demanding an immediate changeover to a new trademark that they did not have any part in choosing.

The franchisor may offer non-monetary or even monetary inducements such as a temporary reduction in royalty payments to encourage the franchisees to change over to a non-infringing trademark without litigation against the franchisor. This loss of income is not a wonderful thing for the franchisor and may kill it but, if cash flow remains barely sufficient, such tradeouts may permit the franchisor to survive the crisis by avoiding expensive litigation and the loss of franchisee goodwill.

c. Prevention. As essential premise of franchising is that the franchise system has a protectable, safe, marketable trademark that brings more of the right kind of customers to each franchisee's business than the franchisee could attract on his own. The customer's perception that he will get what he wants if he goes to a business identified by the franchisor's trademark is a large part of what the franchisor sells to the franchisee and what the franchisee sells to the public. Thus, a small franchisor's first priority should be to put his trademark house in order.

The first item to consider in deciding whether a proposed mark should be adopted is whether it is protectable, i.e., whether the franchisor can exclude competitors from using the term in connection with similar goods and services. This needs to be decided in consultation with an experienced trademark lawyer. Once management decides to adopt and use a trademark, a trademark search should be undertaken to ensure that it is available, and an application for federal trademark registration promptly filed. Not promptly federally registering the franchisor's trademarks risks limiting the franchisor's right to prevent competitors from using the term, and may result in the franchisor's own right to use the mark being destroyed or limited.

It is often very useful to have obtained federal trademark registrations on secondary trademarks and, particularly, on trade dress that the franchisor claims to own. If, for example, the franchised businesses all have a specific look, roof design, or other unique architectural features, Taco Cabana Int'l, Inc. v. Two Pesos, Inc., 112 S.Ct. 2753, 23 U.S.P.Q.2d 1081 (S.Ct. 1982) (arbitrary arrangement of functional features in restaurant structure is protectable), those items should all be reviewed with the trademark attorney concerning the possibility of obtaining federal trademark registrations on them. Once a federal trademark registration on your unique roof design or other unique feature of your franchised business concept has been federally registered for five years, it can become "incontestable" by your filing the appropriate affidavits with the Patent and Trademark Office. 15 U.S.C. §1065; Park 'N Fly, Inc. v. Dollar Park & Fly, Inc., 1055 S.Ct. 658 (1985). Your franchisor possessing incontestable federal trademark registrations on the trade dress incorporated throughout the several franchisees' stores will make it very difficult for them to break away from the franchisor's system.

State registrations are relatively useless except in a few states like Texas. Even in Texas, a subsequent federal registration by another may deprive the state registrant of all rights except previously obtained common law rights. 15 U.S.C. §1115; Burger King of Florida, Inc. v. Hoots, 403 F.2d 904 (7th Cir. 1963).

Since the rest of the world operates on a "first-to-file" system, if the franchisor has any future vision of franchising abroad, the franchisor should consider obtaining a European Community trademark registration and trademark registrations in each of the other countries, such as Mexico in which the franchisor expects to do business in the future.

E. Specific Franchisee Problems

1. Bad Franchisee

a. Problem. The slug will not invest in its franchise unit, will not follow directions, will not cooperate with other franchisees or the franchisor and is not making money.

b. Treatment. Preferably, the unindustrious franchisee can be educated, cajoled, and threatened into performing better. If this does not work, the franchisor can perhaps find a buyer for the franchise. The subject state's franchise and distributor relationship laws should be analyzed. Harper v. BP Exploration & Oil Co., Bus. Fran. Guide (CCH), part 10,785 (D.C. Tenn. 1995) (Franchisor's refusal to renew a minority dealer and appointment of a less qualified non-minority dealer violated the Tennessee Human Rights Act.) The franchisor should document its warnings/ threats/deficiency reports to the franchisee for the dual purpose of hopefully motivating the franchisee to change his ways and to create a rock-solid record to be used offensively in termination litigation or defensively in franchisee rescission litigation, if necessary. Termination litigation should be the absolute last choice, however, since the expense and risks are rarely outweighed by the benefit. In most circumstances, it is preferable to continue to aid the franchisee and continue to aid the franchisee and continue to document your aid, advice and threats and wait until expiration of the franchise at which time you will not renew it to that franchisee.

c. Prevention. Nothing is more important to a franchise system's success than initial franchisee selection. Every franchise sale is the beginning of a long relationship. The up-front franchise fee will not cover future litigation expenses from an unhappy franchisee nor the trouble he stirs up nor the loss of future franchise sales deterred by his bad-mouthing the franchisor to prospective franchisees.

Hungry, motivated, industrious franchisees are much, much preferable to fat and happy franchisees with too much money to worry about monthly losses. Your franchisor should examine potential franchisees more for how they will work out over a period of decades than whether the prospective franchisee will sign a check for the initial franchise fee. A non-exclusive list of questions for weighing prospective franchisees is:

What is his business track record? While a prospective franchisee can be taught how to cook, replace transmissions, or launder clothes, he cannot be turned into a responsible individual by a three-week training course. Most successful franchisees have a track record of long hard work doing something and some, but not much, business background. These are typically people who have supervised others, timely paid their bills, etc. Education is not as important as work experience. For example, has he been climbing the career ladder, or did he level out at a clerk's position?

How Does He Manage His Own Money? Does he have ten credit cards, all of which are extended to the limit? Does he have a new sports car or a five-year-old sedan? Does he have bad credit and a defaulted student loan? Is he involved in his community? Some answers indicate a person who is likely to be a mature, hard worker who will create business goodwill. Some do not.

Where Is His Initial Investment Coming From? Most franchisors require the franchisee to invest an unborrowed sum of money. Most small businesses are not initially profitable and need working capital. Real money obtains more commitment than borrowed money.

Will He Personally Manage The Business? Most small businesses run best if the person physically running the store is the one who invested the money.

Will He Work In The Business Before Committing To It? Some franchisors such as McDonald's Corporation require prospective franchisees to train on a part-time basis with current franchisees before either side makes a commitment. Both sides are better off if either discovers that the fit is not good before it is too late.

Does He Understand The Long, Hard Hours Of Work Involved? Will the spouse tolerate the franchisee's total commitment to the business? Most small businesses require 14 hours a day, seven days a week for the first few months or years.

Is He Suited To This Particular Line Of Business? The supervisory skills needed to operate a transmission shop are different than those needed to control herds of teenagers at a fast-food restaurant. Putting a round peg person in a square hole franchise is a bad decision.

The ultimate issue is whether the prospective franchisee will likely be a happy successful hamburger seller, transmission installer, dry cleaner, etc. for the full term of the franchise agreement. One possibility is to include in the franchise agreement a right for the franchisor to rescind the franchise agreement at any time prior to the franchisee completing training to the franchisor's satisfaction. It may be apparent after a couple weeks of training that the franchisee will never work out. If this is the case, it is easier to cut losses by returning the franchise fee than to suffer with a malcontent within the family for ten years (as long as the franchisee has not already made substantial investments or signed a long-term lease).

2. Restrictions Unacceptable to Franchisee

a. Problem. One or more franchisees assert that the goods and services they are required to purchase in conformity with the franchise agreement's source restrictions and standards are priced higher than competitive goods and have a lesser quality than competitive goods and services and that your franchisor is getting undisclosed benefits from the supplier. They assert that this is a breach of the franchisor's contractual and tort duties of competency, of state and federal antitrust law and state and federal franchise sales disclosure laws.

Further, the franchisees complain about the franchisor's regional and national advertising which states prices that the franchisees do not want to offer. Matter of Reebok Int'l Ltd., FTC File No. 9210117, Bus. Fran. Guide (CCH), part 10,691 (proposed settlement 1995) (Proposed

settlement prohibits Reebok from fixing, maintaining, or controlling the resale prices at which any dealer advertises or sells Reebok shoes and from pressure dealers to maintain or adopt any resale price.)

b. Treatment. While the franchise agreement probably clearly sets out the requirement that the franchisees purchase from sources and in accordance with standards as specified by the franchisor, this is an emotional issue, an important economic issue and a dangerous legal issue. The franchisees are competing on a day-by-day basis with other businesses in the marketplace for each precious customer dollar. They expect the franchisor to help them in this battle, not hinder them. Franchisee complaints concerning this issue should be taken seriously. If the franchisor is not providing the best goods and services at the lowest prices, the franchisees will not be as profitable and the entire system, including the franchisor, will ultimately suffer as competitive chains, franchise systems, and independent kick your franchisees' heads in.

This having been said, once your quality control people credibly explain why the system's standards will be compromised if the complained-of source restrictions and quality standards are not maintained for the particular good or service, then the system's standards should be maintained both for the internal purposes of maintaining the system's quantity purchase discounts, etc., and for the external purpose of presenting a single, high-quality united front to its retail consumers. Exceptions can be given for limited duration experiments to test new ideas, supplies, etc.

Your franchisor can generally enforce reasonable source restrictions. Martino v. McDonald's Systems, Inc., Bus. Fran. Guide (CCH), Part 8477 (N.D. Ill. 1985). To establish an unlawful antitrust tie-in, the franchisee must show that (1) the franchisor has power in the tying market; (2) the two products must be distinct, and (3) there must be a substantial threat that the franchisor will acquire market power in the tied product market. Jefferson Parish Hospital District #2 v. Hyde, 466 U.S.2, 37-39 (1984). Eastman Kodak v. Image Technical Services, Inc., 112 S.Ct. 2097, Bus. Fran. Guide (CCH), part 10,017 (1992) (holding that a tie-in might exist in Kodak's repair parts in spite of its lack of market power in the new copier market) revived interest in antitrust tie-in attacks on franchisor required purchases. Subsequent decisions have generally rejected such claims. Arno Park, Inc. v. Yogurt Ventures USA, Inc., Bus. Fran. Guide (CCH), part 10,589 (W.D. Mo. 1994) (the Yogurt franchise and the yogurt itself were not two distinct products for the purpose of the franchisee's tie-in claim); Krehl v. Baskin-Robbins Ice Cream Co., 664 F.2d 1348, (9th Cir. 1992) (The trademark merely identified the allegedly tie-in product. The trademark is not separate product.) Roy B. Taylor Sales, Inc. v. Hollymatic Corp., Bus. Fran. Guide (CCH), part 10,511 (5th Cir. 1994), (District court holding that supplier's tying its hamburger patty paper to its hamburger patty machines was reversed due to insufficient evidence of injury to competition in the marketplace) (the franchise show antitrust injury to competition in the marketplace. Town Sound & Custom Tops, Inc. v. Chrysler Motors Corp., 959 F.2d 468, Bus. Fran. Guide (CCH), part 9983 (3rd Cir. 1992), cert denied, 113 S.Ct. 196 (1992) (the franchisee did not show antitrust inquiry).

On one hand, the franchisor may not restrict the franchisees to particular supplies for goods that are generally available, such as napkins in a restaurant. Siegel v. Chicken Delight, Inc., 448 F.2d 43 (9th Cir. 1991), cert. denied, 405 U.S. 955 (1992). On the other hand, if the

"secret sauce" is in fact a trade secret, restricting the franchisee to purchasing that item is enforceable. KFC Corp. v. Marion-K Co., Inc., 620 F.Supp. 1160 (S.D. Ind. 1985) (Colonel Sander's secret seasoning is a trade secret), contra, Tominaga v. Shepherd, 682 F.Supp. 1489, Bus. Fran. Guide (CCH), part 9105 (C.D. Cal. 1989) (Supposedly secret pizza recipe comprised unprotectable general advice concerning how to make a pizza.) If, in fact, information about certain suppliers is a secret, this may be restricted information. Proimos v. Fair Auto Repair, Inc., 808 F.2d 1273 (7th Cir. 1987).

If the restrictions and their costs to the franchisee have not been fully disclosed in your franchisor's UFOC Item 16, Restrictions on What the Franchisee May Sell, then your franchisor has a different problem. Depending on how long the franchisee has been in the system, how long the franchisee has previously acquiesced to the source restrictions, etc., it may be necessary to limit the franchise system's restrictions only to certain franchisees. This is because franchisees who did not receive a full UFOC Item 16 disclosure concerning restrictions and costs of those restrictions may have a franchise sales misdisclosure and nondisclosure cause of action that they may bring against the franchisor or complain to the state franchise administrator about. If this problem exists, you must refer to the above long, painful discussion concerning how to deal with franchise sale misdisclosure problems.

c. Prevention. The franchise agreement should be extremely explicit concerning the franchisor's unilateral right to control sources and standards for goods and services. This includes detailed methods for the franchisee to submit proposed changes. UFOC Item 16 should be used as an opportunity to fully and completely disclose source restrictions, the costs of the source restrictions, any benefits the franchisor will receive due to source restrictions, etc. If, for example, the franchisor is going to receive an advertising rebate from a supplier, this needs to be disclosed. Due to recent loosening of antitrust law, most source restrictions will be lawful if fully disclosed to the prospective franchisee in the UFOC.

Having done your legal best to put the franchisee in a straightjacket concerning this issue, however, you need to remind the franchisor that the system will necessarily have to undergo changes over time or competitive systems will overtake the franchisor. Some of those beneficial changes will come from innovative franchisees who suggest new goods or services. The phenomenally successful Dairy Queen BLIZZARD ice cream concoction which practically saved the system was developed by a Dairy Queen franchisee, not the Dairy Queen franchisor. The quandary, therefore, is how to both maintain standardization and encourage innovation.

The franchisor attorney should have enough knowledge of antitrust law to know that vertical price restraints are treated as per se illegal but that, otherwise most vertical restraints by the franchisor on the franchisee will be viewed under the rule of reason. Basically, unless the franchisee can show that the franchisee and franchisor had an agreement concerning established prices and that the franchisor is now punishing the franchisee for breaching the agreement, most franchisee antitrust claims will not succeed. Monsanto Co. v. Spray-Rit Service Corp., 465 U.S. 752 (1984) and Business Electronics Corp. v. Sharp Electronics Corp., 485 U.S. 717 (1988); Matsushita Electric Industrial Co. v. Zenith Radio Corp., 475 U.S. 574 (1986). It is important, however, that none of the franchisor's company stores make any price fixing or other agreement in unreasonable restraints of trade with any franchisee as this would be a per se violation of §1 of the Sherman Antitrust Act. Lovett v. General Motors Corp., 769 F.Supp. 1506 (D. Minn. 1991),

aff'd on other grounds, 975 F.2d 518 (8th Cir. 1992) rev'd on other grounds, 998 F.2d 575 (8th Cir. 1993), cert denied, 114 S.Ct. 1058 (1994).

It is lawful for a franchisor to suggest resale prices to its franchisee as long as they allow the independents to decide whether or not to observe the suggested resale prices. Winn v. Edna Hible Corp., 858 F.2d 1517 (11th Cir. 1988). The franchisor can even compare suggested retail price advertising as long as there is a notice that the prices are available at participating franchisees. Jack Walters & Sons Corp. v. Morton Building, Inc., 737 F.2d 698 (7th Cir.) cert denied, 469 U.S. 1018 (1984). On the other hand, it is per se unlawful price fixing for the franchisor to receive a franchisee's agreement to charge a particular resale price or for the franchisor to unreasonable pressure the franchisees into charging the suggested resale price. Isaksen v. Vermont Castings, Inc., 825 F.2d 1158 (7th Cir. 1987) ("[W]e do not think the court [Monsanto] intended to go so far as to rule that if a supplier telephones a dealer and tells him, 'raise your price by next Thursday, or I'll ship you defective goods,' and the dealer merely grunts, but complies, this is not actionable as an agreement to fix the dealer's price." Id. at 1162.)

In some franchise systems, the problem of encroachment, one franchisee selling another franchisee's area, or the franchisor selling a slightly different line of goods and services in the franchisee's territory, may be a problem. These issues should be specifically addressed in the franchise agreement. "Thou shalt not sell or market outside of thy territory" and "Thy franchisor is not restricted from selling any goods or services through other channels of distribution in your territory." In the absence of contractual requirements, the franchisor is not typically forced to separate squabbling franchisees. Hionis Int'l Enterprises, Inc. v. The Tandy Corp., 867 F.Supp. 268, Bus. Fran. Guide (CCH), part 10,597 (D.C. Del. 1994) (Texas law does not recognize an implied duty of good faith and fair dealing to prevent one distributor from selling in another distributor's territory) but the better practice is to put such powers in the franchisee agreement.

3. Bad Location.

a. Problem. Zig Ziglar could not profitably sell from the franchisor approved or selected franchise location. Worse, the franchisor is the lessor subleasing to the franchisee or has guaranteed the franchisee's payments for a 10-year lease.

b. Treatment. More tens of thousands of dollars are lost at the retail level due to stores being in the wrong location than for any other reason. In the particular above situation, the franchisor has the benefit of being able to evict the franchisee who is not paying the sublease rent (and pulling counterclaims) and the detriment of being stuck on the lease to the landlord. Some franchise chains, such as McDonald's, are so confident in their real estate selecting abilities and are so substantial that an occasional real estate loss will not wipe them out that they elect to purchase the real estate and be the landlord. Small franchisors do not have this luxury. The above described situation is the exact reason the small franchisor cannot afford the luxury of either itself buying the site or being the prime tenant, i.e., one bad location that the franchisor is liable to the landlord for can cripple or kill a small franchisor.

If, upon your reviewing the franchise sales documentation, real estate location documentation, and interviewing the persons responsible for approving the site, you believe that

the franchisee has no sustainable claims against the franchisor for lack of franchisor competence in approving the site, for franchisor misrepresentations concerning the site, etc., then the matter can be turned over to accountants for determination of your best alternative. This is to say that the numbers need to be run and compared as between the money to be lost by closing it and paying on the lease or guarantee. Invariably, the market price for the site will have fallen and the landlord will have little incentive to quickly find a new tenant. It may be in your franchisor's best interest to itself to try to find a new tenant, but at a reduced rent subsidized by your franchisor. More typically, however, the franchisee will, of necessity, claim that he relied on the franchisor's approval of the site, on the franchisor's recommendation of the site, etc. If these claims are present, their sustainability needs to be evaluated and the above toolbox of legal alternatives reviewed.

It also may be desirable to take over the location as a company store in a comprehensive settlement with the franchisee or after evicting the franchisee, both to avoid being sued by the franchisee and because the franchisor may be able to run a store there at a lesser loss because it will not owe a franchisee fee on gross sales.

c. **Prevention**. The multiple tens of thousands of dollars of losses that can be incurred due to having a problem location simply cannot be over-emphasized. Although a real estate expert who quickly finds new sites for franchise stores may seem desirable, it is much more useful in the long run to have a real estate expert who disapproves one location after another until the best, most likely profitable site gains his grudging approval.

Because litigation concerning site selection is so likely and being stuck with a bad lease is so expensive, and the entire real estate contracting and approval process, and all parts of the franchise agreement and franchise documentation that concern real estate, should be particularly bullet-proofed. JRT, Inc. v. TCBY Systems, Inc., 52 F.3d 734, Bus. Fran. Guide (CCH), part 10,652 (8th Cir. 1995) (Franchisor not liable due to its inexperienced real estate advisor approving franchisee's horrible site since the franchise agreement did not obligate the franchisor to itself select a site and there was no evidence that the franchisor acted in bad faith by approving the horrible site); with TCBY Systems, Inc. v. RSP Co., Inc., 33 F.3d 925, Bus. Fran. Guide (CCH), part 10,518 (8th Cir. 1994) (franchise agreement promised to provide "reasonable" assistance in site selection ambiguous and extrinsic evidence admitted to aid in its construction). Generally, in small franchise systems the franchisee will know the local market and will submit a franchise site to the franchisor rather than the other way around. The documentation needs to make clear that franchisor's approval of a site does not comprise the franchisor's recommendation of it nor a guarantee that the franchisee will be profitable there. Numerous written disclaimers and signed releases should be used to ensure that the franchisee cannot later claim any reliance on the franchisor's approval.

4. Franchisee is Too Successful for Your Good

a. **Problem**. The franchisee is making tons of money, believes he can do better without you, will not follow instructions, and appears to be preparing to break away and de-identify.

b. **<u>Treatment</u>.** On the one hand, the franchisor should re-examine what it is and could be doing for the franchisee, i.e. give the franchisee tender loving care and personal attention to regain the franchisee's loyalty and retain the franchisee's substantial royalty payments. Unfortunately, however, tremendously successful franchisees are both more emotionally and monetarily capable of litigating against the franchisor than moderately successful franchisees. In the meantime, therefore, the franchisor should prepare for battle with the franchisee by collecting admissible evidence, reviewing the franchisee agreement and letting time create more ratification type defenses against whatever complaints the franchisee has. As discussed above, it may be necessary every few years to initiate litigation against a single uncooperative franchisee that has not been in compliance with the franchise agreement, more for the purpose of letting all of the other franchisees gently feel the mail beneath the velvet glove than for any expected monetary recovery from the particular sued franchisee.

c. **<u>Prevention</u>**. The preventive step is to make each franchisee successful but to not let any one franchisee become too powerful. There is much to be said for not letting franchisees own too many locations. A franchisee who owns one location emotionally feels he or she is a small part of a large system and monetarily cannot afford litigation. A franchisee with many locations has probably staffed up sufficiently to be running his locations without much franchisor assistance, has his own headquarters and attorney, is emotionally and practically cut off from any need for franchisor's support, and has sufficient monetary capital to afford litigation with the franchisor. Indeed, if a multi-unit franchisee stops paying royalties and, instead, pays those royalties to an attorney for the duration of the suit, that franchisee may actually be saving money during the pendency of the suit. The franchisor, however, being structured to be dependent on that royalty may find it difficult to simultaneously both (1) do without the substantial royalty and (2) pay substantial attorney's fees during the litigation. A franchisee can, therefore, be too successful for the franchise system's good if the franchisee's success provides the franchisee with a sufficient power base to slug it out with the franchisor in protracted, expensive litigation.

5. <u>Liability for Franchisee Acts</u>

a. **<u>Problem</u>**. Your franchisor receives service of a complaint alleging that it is vicariously or directly liable due to a customer being injured by scalding hot coffee at a franchisee's store, the store not being accessible to disabled persons in violation of the Americans with Disabilities Act, a customer being injured by a slip-and-fall at the franchise location, franchisees advising customers that their automobile transmissions need to be worked on when they do not etc. <u>Compare</u> <u>O'Banner v. McDonald's Corp.</u>, 1995, Ill. App. Lexis 362 (1995), (The public has come to believe that McDonald's was responsible for the condition of the premises of all McDonald's franchise locations and thus McDonald's is vicariously liable for a slip and fall at a franchised McDonald's restaurant), with, <u>Mobile Oil Corp. v. Bransford</u>, Bus. Fran. Guide (CCH), part 10,605 (Fla. S.Ct. 1995) (Mere use of franchisor's trademarks and advertisements, absent more, did not indicate an agency relationship. Franchisor not vicariously liable for assault on a franchisee's customer by one of the franchisee's employees.)

b. **<u>Treatment</u>**. Immediately inform the insurance carrier (hopefully, the franchisor has appropriate insurance) and hire local counsel. At this point, the facts of the particular case are fixed and your franchisor is stuck with them.

c. Prevention. First, every effort must be taken to ensure that the customer is apprised of the fact that the franchisee is in control of day-to-day operation of the franchise. This may include a prominent sign announcing to the consuming public that the unit is independently locally owned and operated by XYZ, Inc. You may (as a service to the franchisee) install such a sign with a color, 8-inch by 12-inch color portrait of the individual franchisee owner in the franchisee's doorway. If the franchise uses agreements with its with its customers, they should prominently state that the customer's agreements are solely with the franchisee and not the franchisor. Each franchisee employee can agree in writing to look solely to the franchisee. Use your imagination and do everything possible to deprive the harmed customer, employee, or vendors of the ability to assert to the jury that he was relying on the franchisor for his safety, the product's efficacy, etc.

Second, the franchise agreement and operations manual need to be written to give the franchisor the right to enforce necessary quality control measures but also with an eye toward explicitly giving the franchisee day-to-day control over every individual transaction in which a customer might be injured or disappointed. The more the franchise agreement gives the franchisor the right to control everything, the better evidence the franchise agreement is for the injured plaintiff's claims that the franchisor had the right to control the particular transaction, the franchisee was merely the franchisor's agent, and the franchisor is legally responsible for the injury. Compare, Raymond R. Martin v. McDonald's Corp., 157 Ill. Dec. 609, 213 Ill. App. 3d 487, 572 NE2d 1073, Bus. Fran. Guide (CCH), part 10,547 (Ill. App. Ct. 1991) (By outlining and implementing security procedures at the franchisee's store, McDonald's voluntarily assumed the duty of care and protection and was thus liable for the death of one of the franchisee's employees during a robbery of the franchise outlet), with, Neff v. American Dairy Queen, Inc., 879 F. Supp. 57 (W.D. Tex. 1994), (Franchisor's right to veto modifications to the franchised facilities did not constitute "operating" within the meaning of the ADA absent evidence that the franchisor actually exercised that right in a manner inconsistent with the ADA). The franchise agreement and operations manual must be re-read with this dichotomy in mind.

There is not, however, any perfect defense against the franchisor being vicariously liable for the franchisee's acts, given that the franchisee has the franchisor's name up there on the franchisee's marquee for every potential customer to see and that the franchisor must retain some control over what the franchisee delivers to the public. Monica, Franchisor Liability to Third Parties, 49 Mo. L. Rev. 309 (1984).

Therefore, to the extent possible, each franchisee should be required to maintain its own insurance which names the franchisor, its officers, employees, agents, etc. as additional primary beneficiaries. The insurance company should be approved by the franchisor and the policy should state that it cannot be canceled without the insurance company giving the franchisor 30 days prior written notice. Sigalow, Insurance and Indemnification Provisions In Trademark License Agreements, The Licensing Journal 31 (Sept. 1992). Depending on the size of the claim and the franchisee's net worth, this may or may not be helpful. The franchise agreement should give the franchisor the right to control and settle such litigation and require the franchisee to fully indemnify the franchisor, its officers, employees, agents, etc. from any liabilities arising due to anything involving the franchisees franchise.

F. Franchisee Concerted Action

1. Rebellious Franchisees

a. **Problem**. A loyalist franchisee informs the franchisor of a planned royalty strike or multi-franchisee suit.

b. **Treatment**. If likelihood of concerted anti-franchisor action by the franchisees is high, one response is to preemptively sue the ringleader for breach of the franchise agreement, interference with the other franchisee's contracts, etc. Discovery should be immediate and extensive. This will often cause the other franchisees to hang back to see what happens. The franchisor president and other top officers should visit key franchisees at their locations to informally visit and see what additional assistance the franchisor can give, what information can be learned, etc.

c. **Prevention**. Do not sell franchises to prospective franchisees whose history shows they are likely to be troublemakers. You should continually remind your franchisor that your well-prepared franchise agreements cannot keep the franchisees in line if they do not feel they are getting their money's worth in value received for their franchise royalties. The franchisor should be encouraged to do everything possible to create franchisee loyalty, including personally visiting the franchisee's stores and informally meeting with small groups of franchisees to exchange ideas, take their pulse, etc. Constant informal personal communication between the franchisor's top officers and the franchisees is the best insurance against unhappy franchisees joining together for concerted action against the franchisor. Consideration should be given to forming an adversary council or franchisor sponsored association.

2. Franchise Associations

a. **Problem**. The franchisor receives a letter signed by most of the franchisees stating that they have formed an association or a union and that the worst troublemaker is their spokesperson.

b. **Treatment**. The unexpected receipt of such a letter indicates that the franchisor has not been keeping up friendly, informal, personal communications with the franchisees. The usually preferable alternative once such a letter is received is to personally visit with the most influential franchises and make a counter offer of a franchisor/franchisee advisory counsel or a franchisor-sponsored association. Powerful inducements to the franchisees for joining such an advisory council or association instead of forming their own group are that the franchisor may be willing to pick up the tab for annual meetings and for officers' meetings at the franchisor's headquarters, may be willing to set up informal mediation or arbitration of minor franchisee disputes by panels that have the participation of other franchisees, etc. The franchisor will argue that if the franchisees choose to go their own way, they will have to pay their association's expenses themselves and it will be unhealthy for the franchise system for a franchisee association to create a hostile relationship between the franchisor and the franchisees by excluding the franchisor. Anything that is bad for the system as a whole will ultimately hurt each franchisee in its pocketbook, as franchise services decline, resalability of the franchises

declines, etc. Both sides will hire expensive lawyers that will cost us both an arm and a leg. Everyone will make more money if we join together in a franchisor-sponsored advisory counsel or association, and so on.

Several states have laws to protect the franchisee's right to associate. This includes Arkansas, California, Hawaii, Illinois, Michigan, Minnesota, Nebraska, New Jersey and Washington. While franchisees have the right to from their own associations, Kruezer v. The American of Periodontology, 735 F.2d 1479 (D.C. 1984), franchisor-sponsored advisory counsels or associations will necessarily have some control or input from the franchisor and will be better for the franchisor than having the franchisees unite in an association where the franchisor has no input. Such associations often end up hiring their own attorneys and developing and adversary relationship with the franchisor. For example, the association of Meineke dealers has recently caused a class action suit consisting of every Meineke franchisee to be certified against their franchisor, Meineke Mufflers. Broussard v. Meineke Discount Muffler Shops, Inc., Bus. Fran. Guide (CCH), part 10,729 (W.D.N.C. 1995)

c. Prevention. The preferable method of prevention is for the franchisor for itself to initiate such thorough and formal communication with all of the franchisees through visits to the franchisee stores and annual franchisee meetings at the franchisor's headquarters that the franchisees do not feel the need to set up an association. Many franchisors find it advisable to preempt independent franchisee associations by forming franchisee advisory councils or franchisor-sponsored associations. The earlier these formal or informal advisory councils or franchisor-sponsored associations are set up, the more control the franchisor has in their structure. There is no perfect structure for these organizations, however. Too much franchisor control defeats their purpose. Too little franchisor control leaves them open to being hijacked by hostile franchisees. It is best to create these organizations only with the input of the franchisees. This is more likely to get the franchisees to accept the franchisor/franchisee advisory council or franchisor-sponsored franchisee association as being their legitimate voice.

G. Transfer and Renewal

1. Request for Transfer to a Bad Franchisee

a. Problem. The franchisee wishes to sell out for an above-market price to a buyer who will likely fail. The franchisee may not have accurately disclosed his results to the prospective buyer and/or the location will not support the buyer's proposed debt burden. If you do not approve the transfer, the current franchisee may sue alleging that the franchisor used bad faith in unreasonably exercising the franchisor's discretion to disapprove transfer.

b. Treatment. First, be aware that the situation is one that might involve the franchisor in litigation. To help insulate the franchisor from liability, many franchisors do not charge a transfer fee, even though a transfer is the occasion of some expense to the franchisor. Charging a transfer fee makes it more likely that the franchisor will be liable to an unhappy transfer fee who alleges that the franchisor is liable for the transferee's full losses

because the franchisor participated in and profited from the transaction allegedly knowing that the transferee would likely lose money if it purchased the franchise.

Hopefully, under the franchise agreement you drafted, the current franchise does not have a right to sell its franchise to just anyone. R.A., Inc. v. Anheiser-Busch, Inc., Bus. Fran. Guide (CCH), part of 10,820 (Minn. 1996) (since manufacturer's approval of transfer of distributorship was condition precedent and manufacturer had not approved the transfer, no valid transfer took place). The prospective new franchise should be required to fill out all of the normally required prospective franchise application materials. Perhaps the prospective franchisee will not qualify to purchase the franchise. If the franchise agreement contains terms permitting the franchisor to disapprove a sale where the new franchisee will have to pay so much that it will likely fail, that term should be enforced where applicable.

Any franchisor's approval of a transfer should be upon a form which contains (1) all possible indemnifications from both parties and (2) indemnifications from both parties to the franchisor against any actions either party may take against the franchisor related to the sale and transfer.

c. Prevention. The franchise agreement should set out in excruciating detail the rights the franchisor has to require a proposed transferee to meet the franchisor's standards, the franchisor's right to reject any proposed sale due to the franchisor's determination that the sales price and terms are not in the best interest of the franchise system, to require the franchise to indemnify the franchisor against any problems caused by the transfer, to release any claims against the franchisor at the time of transfer, etc. The author's preference, as discussed above, is that the franchisor not receive a transfer fee because, under the Texas Deceptive Trade Practices Act, receiving a fee may make the franchisor liable for misrepresentations which may occur in the transaction, in spite of the franchisor not being in privity with the transferee. This is particularly true since the franchisor is not in control of the representations being made to induce the transaction.

2. Request for Approval to Move to a Bad Location

a. Problem. The franchisee's site lease is coming up and the franchise wants to move into a location that your real estate expert advises is a loser. If the franchisee moves into the new location and fails, it is a black mark against the entire franchise system. The franchisee insists that it is the best location for his franchise which must move now.

b. Treatment. The text book answer is to refuse to permit the franchisee to transfer to a site your real estate expert advises will be a loser. All possible legal precautions should be taken, however, because the disappointed franchisee sincerely believes you are wrongfully depriving him of his paid-for right to make a profit. If your real estate expert subsequently suggests a site that the franchisee moves to and this is not profitable, the franchisee will likely sue the franchisor. Great care should be taken to provably deliver to the franchisees all information available to the franchisor concerning the sites in question so that the franchisee cannot assert to the jury that your franchisor withheld any information.

This is particularly dicey if the location ultimately recommended by your franchisor's real estate expert is expected to have a higher volume of sales but also has a higher rental rate. Since the franchisor's royalties are based on the franchisee's gross sales rather than on the franchisee's net profits, the franchisee will claim that the franchsior unlawfully directed the franchisee to a location that would have a higher sales volume and, thus, higher royalties rather than to the site with lower sales volume but much lower rent and, therefore, higher net profits to the franchisee.

Final approval should be conditioned on a release of all franchisee claims. This will, however, likely be ineffective against any non-disclosure or misrepresentation claims the franchisee may later learn about with respect to the site transfer. Thus, all information the franchisor has about the sites should be provably given to the franchisee.

c. **Prevention**. The only prevention steps are to be aware that this may be litigation problem; put the franchisor's right to disapprove new sites in the franchise agreement; take care to fully apprise the franchisee in writing of all information available to the franchisor concerning the subject sites, document everything and condition the relocation on obtaining a release.

3. **Franchise Renewal Terms**

a. **Problem**. The franchisee wants to renew the franchise but not on franchisor's offered revised franchise agreement with higher royalty and advertising contribution rates and harder terms.

b. **Treatment**. Review applicable state law and the franchisee's current franchise agreement. Assure yourself that no representations were made concerning renewals that are not in the agreement. If the bases are covered and there are no problems, the franchisee needs to sign the system's new standard agreement or the resultant nonuniformity in the system's agreements will cause political problems with other franchisees and state law UFOC disclosure problems.

c. **Prevention**. It should be provably disclosed to the franchisees from the beginning that the renewal will be upon the then current franchise agreement being offered by the franchisor which may have higher fees and different terms. This is one of the ways that a complete UFOC helps the franchisor because this must be disclosed in UFOC Item 17, Renewal, Termination, Transfer and Dispute Resolution. The different franchise agreement should not come as a shock to the franchisee.

4. **Termination and Non-Renewal**

a. **Problem**. Your franchisor wants to terminate or not renew a franchisee.

b. **Treatment**. Review all applicable state franchise relationship and dealership laws. Review and again review the provable facts and the franchise agreement for all possible reasons for termination and non-renewal. Document ahead of time the factual reasons for termination or non-renewal in ways that you will be happy to have critiqued in front of a jury.

If the franchisee is not performing satisfactorily, send unfavorable performance reviews/warnings/threats so there will be plenty of admissible evidence to support the decision and so the franchisee is not surprised.

Any termination or non-renewal should not come as a shock to the franchisee. First, if it does come as a shock to the franchisee, it increases the likelihood of litigation. Second, if the franchisee has plenty of advance warning, he or she may remove the problem by either shaping up, selling out to a new, approved franchisee, or simply closing its location and making a deal with your franchisor. Often, a franchisee will not litigate a termination if he has seen his failure being documented and it unavoidably coming for a long time.

c. **Prevention**. Every termination or non-renewal must be viewed by management as a failure of the franchise system in some respect and not merely as the franchisee's failure. It may be a failure to screen out the loser franchisee up front, a failure to find the right location, a failure to provide proper training, etc. (It is, of course, possible that the failure is due to changed market conditions, etc., having nothing to do with the franchise system. Nevertheless, the first impulse should be to re-examine what was done and what could be done better in the future.) Every termination and failure to renew is an opportunity for the franchisor to spend tens of thousands of dollars in expensive litigation. On the other hand, if the franchisee needs to be terminated for the good of the system, the only question is how to best do it, not whether to do it.

H. Insolvency and Bankruptcy

1. Insolvent Franchisees

a. **Problem**. The franchisee's landlord and principal vendors advise that franchisee is in arrears. The franchisee may either have a short-term cash flow problem but a reasonable chance to recover in the long run or be hopelessly covered up in debt. Alternatively, the franchisor receives a Chapter 11 bankruptcy notice together with the notification that the bankruptcy estate plans to reject the franchise agreement and sell the franchised business' assets to the franchisee's brother who will carry on an identical de-identified business from the same location. Comment, License and Franchise Agreements as Executory Contracts: A Proposed Amendment to § 365 of the Bankruptcy Code, 59 U.Col.L.R. 129 (1988).

b. **Treatment.** The above multiple ways of stating the problem highlight the difficulty in deciding how to deal with an insolvent franchisee that is not yet bankrupt. The its-just-a-temporary-cash-flow-problem franchisee may (1) through luck, marketing and desperation, pull through; (2) cut more and more corners in desperation, thus delivering a shoddy franchise system image to the public; (3) elect to pay his final cash reserves to a litigation attorney who will sue the franchisor for fraudulent misrepresentation in the sale of the franchise; or (4) take a Chapter 11 filing, thus effectively stiffing the franchisor for any extended credit and turning the business into a competitor.

The first things that should be done as soon as the problem becomes apparent are to consult with competent bankruptcy counsel and blunt the insolvent franchisee's litigations odds

by obtaining ratification of any franchisor misdeed by agreeing to a workout agreement which includes stretching out the franchisee's obligations to the franchisor, and a perfected security interest. Talton v. Mac Tools, Inc. Bus. Fran. Guide (CCH), part 10,626 (N.C. Ct. App. 1995) (Franchisee's work out agreement with the franchisor contained a mutual release which barred franchisee's subsequent suit.) The security interest must be filed to be perfected. Bankruptcy counsel will advise that the franchisor will be better served if the franchisee is terminated before it takes bankruptcy. Once the franchisee takes a Chapter 11 bankruptcy, the 11 U.S.C. §362 automatic stay will prevent the franchisor from terminating the franchise agreement and will likely make the franchisee a "debtor in possession" continuing to operate the franchised business. The franchisee will then consider whether it is to his advantage to either accept the franchise agreement and continue to pay royalties, etc. or to reject it and to try to continue to operating the business in the same location but with different trademarks, etc. But see, In Re Printronics, Inc., Bus. Fran. Guide (CCH), part 10, 828 (Bankr. Fla. 1996) (Bankrupt franchisee's rejection of its franchise agreement did not preclude enforcement of the franchise agreement's non-competition covenant). It is important to remember that any individual who is riding a failing business into the ground is very desperate and may take desperate long-odds gambles to try to salvage something. As always, the franchisor should attempt to maintain an open, informal communication with the franchisee and continue to obtain as much information as possible from the franchisee. This includes the small franchisor's principal officers personally visiting the franchisee to show their concern and to gather information.

Whether the franchisor is subleasing the location to the franchisee or is obligated in any way on the lease is of paramount importance.

c. Prevention. The franchise agreement should grant a security interest in all of the franchisee's business assets and, ideally, the franchisor should follow up on this by filing a UCC-1 and real estate lien against those assets to perfect that interest. A perfected first lien, however, may not be possible because of the franchisee's other necessary obligations to the bank and the landlord. Further, while the franchisor is glad to be lessor subleasing to the franchisee if the location is wonderful, Barn-Chesnut, Inc. v. CFM Development Co., Bus. Fran. Guide (CCH) part 10,670 (W. Va. S.Ct.App. 1995) (Franchisor not required to renew franchisee's expired lease) the franchisor may take a heavy real estate hit if, as discussed above, the location is a loser. Most small and start-up franchisors cannot afford the risk of being on a long-term real estate lease in a distant city which turns out to be a loser and, therefore, reduce their risk by not themselves entering into such leases and not guaranteeing such leases. Some landlords will give the franchisor an option to step into the franchisee's shoes as the lessee if the franchisee becomes delinquent in its lease payments. This may keep the wonderful location if the franchisee runs the business into the ground.

The franchise agreement should prohibit the franchisee from granting a security interest in his business' assets without the franchisor's consent. Although the franchisor will typically give this consent, this at least lets the franchisor know who the secured parties are. The franchise agreement should prevent the franchisee from selling the business' assets except in the ordinary course of business, restrict, by pledge or otherwise, the franchisee's corporation's stock, grant the franchisor an option to purchase the franchisee's business assets including its lease rights in the event of a franchisee default and having this incorporated into the franchisee lease to obligate the landlord to recognize the franchisor's right of possession of other premises in the event of

franchisee default etc. A long list of events permitting the franchisor to effect an immediate termination will give the franchisor an option to terminate the franchise agreement after it learns of the franchisee's insolvency but before the franchisee takes bankruptcy. This is important to keep the franchise agreement from becoming property of the bankruptcy estate. If the franchise agreement's termination clause contains cure provisions and the franchisee takes bankruptcy before the cure time periods have expired, then the 11 U.S.C. §362, automatic stay, may prevent you from terminating the franchise agreement.

The franchise agreement should require the franchisee to pay royalty and advertising fees through the full duration of the franchise agreement as the net present value of these future estimated fees may comprise a substantial claim on the bankrupt franchisee's estate. In Re Montcastle, Bus. Fran. Guide (CCH), part 10,534 (Bankr. W.D.N.C. 1994). The more people and entities whom you can get to guarantee the franchisee's obligations to the franchisor, the better.

2. Insolvent Franchisor

a. Problem. More bills than money.

b. Treatment. Bring in bankruptcy counsel as soon as possible to discuss a Chapter 11 bankruptcy or other workout with creditors. Increase income by selling several new franchisees for the initial franchise fee profit. Reduce expenses by cutting fat and muscle and maybe bone. Sell freedom or rights of first refusal to other territories or area development agreements or royalty reductions to franchisees for up-front money. Sell equity or take on debt.

If bankruptcy looms, tax counsel should advise what taxes are the responsibility of the franchisor's principals. These need to be paid even if everyone else gets stiffed. If there is not enough money even to pay all such taxes, then at least get trust fund-type taxes such as employee withholding paid, as those are non-dischargeable obligations in the principals' personal bankruptcies.

A Chapter 11 bankruptcy can be very useful if the conditions are right. The franchisor must have a class of friendly creditors who will only get paid if the franchisor continues in business and must have enough cash to fund bankruptcy attorney expenses (a lot!). The friendly class of creditors, perhaps employees who want to keep their jobs, vendors who hope to keep selling to the franchisor for a profit, etc. will vote for the franchisor's debtor-in-possession plan for continued operations which involve cramming down the other classes of creditors, i.e., the bank and unsecured creditors. This may leave franchisor's management in control, reduce debt, and wash all franchisor liabilities created by past bad acts and result in a stronger franchisor.

c. Prevention. The most common causes of insolvency are over-expansion, under-capitalization or sales misrepresentations which come home to roost. Consequently, the most useful preventative measure is for the franchisor to expand slowly within its monetary and nonmonetary capability to support the expansion and to be careful about its franchise sales.

The small franchisor's key intangible assets, its trademark, trade dress, recipes, etc, and even some of its tangible assets can be owned by the franchisor's parent company and licensed to the franchisor. There will be an alter ego attack on this arrangement. Alternatively, the franchisor's parent company may establish the franchising company with a loan secured by substantially all of the franchising company's assets.

I. Dispute Resolution

1. Litigation with Franchisees

a. Problem. Someone, either the franchisee or the franchisor, is losing money because of the relationship. Whoever is losing money cannot let this go on forever, and the other side knows it. Eventually, someone sues first.

b. Treatment. The franchisee asserts "you lied to me" against the franchisors "the franchise agreement says I win." Franchise litigation is more similar to general commercial litigation then it is different. A good review of Texas law concerning franchise litigation is found in John Lewis, Franchise Litigation in Texas: Analyzing Claims and Defenses, 19 St. Mary's L.J. 663 (1988). If litigation cannot be avoided, be aware of the subject state's termination laws and consider offering longer notice periods than required in the franchise agreement. Al Bishop Agency, Inc. v. Lithonia-Division of Nat'l Service Industries, Inc., 474 F. Supp. 828 (E.D. Wis. 1979). In contrast to franchise disclosure laws, franchise relationship laws may actually change the terms of the franchise agreement. Thus, you must check applicable state laws before taking any action in this regard. Since the franchisor is likely better financed, it usually front loads the expensive discovery steps. Usually your franchisor has more confidential financial data and other information that it desires to keep from prying eyes than does the franchisee. A two-stage protective order is often essential, the first phase restricting dissemination and use of any confidential information only for the purposes of litigation, the second phase being for attorneys' eyes only. Nevertheless, the discovery process can be catastrophic if the franchisor has skeletons in its closet that it was hoping would slowly be taken care of by the expiration of statutes of limitation, delay, etc. This can change the focus of the litigation and cause other franchisees to file their own suits based on the newly discovered facts.

If the franchisee's claim is based on information that was not disclosed in the UFOC, the franchisor will assert that the substance of the information was disclosed informally, Duncan Donuts, Inc. v. H.W.T. Assoc., Inc., 181 A.D.2d 711 Bus. Fran. Guide (CCH), part 9986 (2d Dept. 1992). If the franchisee relied on any UFOC earnings claims, the franchisor will assert that the franchisee have noticed the bold print statement that the franchisee could not rely on the representation, State of Wisconsin v. The Kis Corp., Bus. Fran. Guide (CCH), part 9886 (Wis. Cir. Ct. 1991) ("profit planner" had disclaimer).

c. Prevention. Litigation should be avoided if possible as the cost of winning will likely be tens of thousands of unrecoverable attorneys' fees while any single franchisee victory will be a threat to the system's survival for the collateral estoppel reasons discussed above. If the franchisee owns only a single franchise location as opposed to owning multiple franchises, then the franchisor has much more power vis-à-vis the franchisee. A

franchisee with a single franchise often simply cannot afford litigation. A first prevention step, therefore, is to not permit many multiple unit franchisees.

Numerous ratifications by the franchisees are very useful. Any time a franchisee is behind in its royalties or needs some additional assistance, or desires any franchisor favor or forbearance is an occasion to obtain a signed ratification or release. The laborious use of procedures and forms to document the franchisor's assistance to and communication with each franchisee as discussed above will be useful in either avoiding or wining the suit. Mediation is usually preferable to litigation and arbitration often is. This is particularly true where the disputes concern an ongoing relationship problem but neither side wants to end the franchise relationship.

2. Breakaway Franchisee.

a. Problem. The breakaway franchisee either de-identifies, taking your franchisor's name off the marquee and proceeding forward, or simply continues forward without even changing the marquee.

b. Treatment. Your franchisor may not want to throw tens of thousands of dollars down the drain on litigation which may not produce a significant monetary recovery and the break-away franchisee may be leaving because your franchisor never provided the promised services and benefits. Rather than fighting each other to exhaustion, sometimes a "divorce" in which the franchisor and franchisee agree to let the franchisee continue in business but to thoroughly de-identify or in which the franchisor buys the franchisee out makes more sense for both sides. This saves money and energy for making the franchise chain more likely successful in the marketplace and eliminates the possibility of losing at trial which would create an adverse collateral estoppel problem.

Alternatively, litigation will be immediately be commenced and vigorously pressed. Because all of the other franchisees in the system will be watching, it is important that the break-away franchisee be hit as quickly and as hard as possible. To avoid being relegated to contract claims for damages, the franchisor must rely on its covenant not to compete clauses, Peter J. Klarfeld, Covenants Against Competition in Franchise Agreements (1992), and tort clauses of action such as trademark infringement, misappropriation of trade secrets, other misappropriation theories, deception of the consuming public, etc. If the franchisee has not de-identified, your explanation to the court that the public is being deceived and that your franchisor may be vicariously liable for any sins currently committed by the breakaway franchisee will typically induce prompt relief. Specialty Bakeries, Inc. v. City Bagels, Inc., Bus. Fran. Guide (CCH), part 10,648 (D.C. Pa. 1995) (Terminated franchisee enjoined from continuing operation in its formally franchised location in part because of franchisor's legitimate interest in enforcing its non-competition provisions, protecting its trade secrets, and its trademark rights.)

c. Prevention. The first prevention step is to appreciate that problems of this type will occur and to set up and document every possible attack against the breakaway franchisee.

(1) The franchisee agreement certainly needs to contain noncompetition clauses (with the understanding that covenants not to compete are not enforceable in some states). The more people who execute covenant not to compete clauses -- the spouse, the children, key franchisee employees -- the better.

(2) You should obtain federal registrations for all of the system's trademarks, Duncan Donuts, Inc. v. Mercantile Ventures, Inc., 32 U.S.P.Q.2d 1460, Bus. Fran. Guide (CCH), part 10,521 (W.D. Tex. 1994) (breakaway franchisee held to have intentionally counterfeited Duncan Donuts marks entitling Duncan Donut's franchisor to treble damages and attorney's fees against the franchisee and its owners and officers) and trade dress Two Pesos, Inc. v. Taco Cabana, Int'l, 112 S.Ct. 2753 (1992); and be vigilant during the course of the franchise relationship to ensure that the franchisee is in fact incorporating the trademarks and trade dress into the franchisee's store front, interior decorations, products, inventory, etc. This will make it expensive for the franchisee to de-identify. The franchisor's alleged breach of the franchise agreement does not justify the franchisee's failure to pay for use of the trademark and other system indicia. S&R Corp. v. Jiffy Lube Int'l, Inc., 968 F.2d 391 (3rd Cir. 1992); Burger King Corp. v. Majeed, 805 F. Supp. 994, Bus. Fran. Guide (CCH), part 10,077 (S.D. Fla. 1992).

(3) The franchise agreement should require the franchisee to immediately turn over or immediately give the franchisor an option to purchase several important items. In one franchise system, this may be the franchisee's customer list developed using the franchisor's trademarks or the telephone numbers. In another system, it may mean the recipes or secret formulas.

(4) If certain pieces of equipment are critical, the franchise system may be structured so that those pieces of equipment are leased to the franchisee rather than sold. A term in each lease agreement will be that the lease is for only so long as the franchisee remains in compliance with the franchise agreement. Of anything is patentable, it should be patented.

(5) All of the franchise system's written materials should bear copyright notices and actually should have copyright registrations. McGawan and Cone, The Increasing Value of Copyright Protection In A Franchise Context, Franchise L.J. 1 (Fall 1988) This will permit you to additionally sue the breakaway franchisee for copyright infringement.

(6) Items which are arguably secret, such as the operations manual and instructions manuals, etc. should bear trade secret notices. All employees and other persons who have access to these items should sign trade secret agreements. This will permit you to sue the breakaway franchisee for infringing the franchisor's trade secret rights by making unauthorized use of the franchisor's trade secrets. Western Temporary Services, Inc. v. Kassler, Bus. Fran. Guide (CCH), part 10,572, Cal. S.Ct. 1994 (Franchises helped their daughters set up identical business. Court held that the franchisees had misappropriated the franchisor's trade secrets.) Snelling & Snelling, Inc. v. Armel, Inc., 179 U.S.P.Q. 699 (W.D. La. 1973) (Training manuals, etc., held to be protectable trade secrets), contra, Scott v. Snelling & Snelling, Inc., 732 F. Supp. 1034 (N.D. Cal. 1990) (Same training manuals, etc. held to be used by others and unprotectable). Cottman Transmission Systems, Inc. v. Medody, 851 F. Supp. 660 (E.D. Pa.

1994) (Training course information a protectable trade secret, since it was only seen by people who signed a trade secret agreement). Failing to properly protect the trade secrets causes them to be abandoned.

(7) The franchise agreement should require the franchisee to pay its royalties, advertising contributions, etc., to the franchisor through the full term of the franchise agreement. If the result of the litigation is that the franchisee may leave but is required to pay franchisor's full contract damages, i.e., the royalties and advertising contributions that were due during the full course of the agreement, the resulting monetary judgment may itself bankrupt the breakaway franchisee.

(8) As many franchisee family members as possible should guarantee the franchisee's performance.

The proper way to prevent the breakaway franchisee problem is to realize that it will occur some day and to attempt to create every possible cause of action and to create wonderful admissible evidence that will support each of those causes of action against the breakaway franchisee.

3. Arbitration

a. Problem. Run away or inexperienced or nutty or split-it-down-the-middle arbitrator.

b. Treatment. The parties often forget that any agreement they reach at any time is binding on the American Arbitration Association or whatever organization is running the arbitration and on the arbitrator. The parties can, thus, agree on discovery schedules, mediation, extensions of time, or anything else which suits both parties' interests.

c. Prevention. The good news is that arbitration agreements are generally held to be enforceable and even preempt otherwise applicable venue and jurisdictional requirements to bring the dispute to the franchisor's headquarters city if the arbitration agreement requires it. Allied Bruce Terminex Co. v. Dobson, 115 S.Ct. 834, 839-40 (1995); Carnival Cruise Lines, Inc. v. Shute, 111 S.Ct. 1522 (1991); Stewart Org., Inc. v. Ricoh Corp., 108 S.Ct. 2239 (1988); Burger King v. Rudzenisz, 105 S.Ct. 2174 (1985); Shearson/American Express, Inc. v. McMahan, 107 S.Ct. 2332 (1987).

You can draft arbitration clauses to reduce the possibility of problems. A non-limiting list of examples is: (1) limit the possible arbitrators to those who belong to the American Bar Association Forum Committee on Franchising and have at least ten years of franchise experience or some other qualification which is more likely to result in an arbitrator with experience in franchising. (2) Require that the parties submit a detailed pretrial order and that the Federal Rules of Evidence be strictly applied. It is more likely that the franchisee will want to present a loose and emotional attack on the franchisor's sales representations and competence. A requirement that all testimony and exhibits be listed ahead of time and making the rules of evidence applicable limits this. This will also help keep out damaging hearsay from other disgruntled franchisees. (3) Provide that the arbitration must be individual arbitration to ensure that multiple franchisees do not all join into the one multi-franchisee arbitration against your

franchisor. (4) Require that the final arbitration award state that it is in the nature of an enforceable settlement so it cannot be used as a basis for offensive collateral estoppel by other franchisees in the event that your franchisor loses.

Larger franchisors often disfavor arbitration because (1) small franchisees cannot afford to litigate against a large franchisor and so most suits never get to a jury; (2) many arbitrators split-the-difference between the parties instead of enforcing the franchise agreement's terms like a judge would; and (3) no appeal. The countervailing argument for a small franchisor is that he cannot afford litigation much better than the franchisee can.

4. Protecting the Franchisor's Principals

a. Problem. The franchisee's claim or counter-claim names the franchisor's principals individually.

b. Treatment. Standard motion practice.

c. Prevention. Educate the principals concerning what acts might make them personally liable, i.e., anything they personally promise, misrepresent, fail to disclose, and any unlawful acts that they authorize. General advice: (1) Screen principals from direct contact with prospective franchisees, except for structured, set piece general presentations; (2) disclose all possibly material facts in the UFOC and keep it updated; (3) require all franchisees and all of the franchisor's employees and franchisor's officers, directors, etc., to enter an arbitration agreement in their individual capacities. Pepe Int'l Development Co. v. The Pub Brewing Co., ___ S.W.2d ___ (Tex. App.--Houston [1st] 1996) (arbitration clauses signed in representative capacity not binding on parties individually); and (4) observe all corporate formalities.

On a law school exam, the correct answer would be to keep the franchisor's principals from ever (1) meeting with franchisees, (2) authorizing any act, and (3) ever showing up at the franchisor's headquarters. This is not, however, how a small business' officers manage its affairs. While the large franchisor may have layers of management, regional franchise sales managers, etc., at a small franchisor everyone does a little bit of everything. If the phone rings more than three times, the small franchisor's president answers it. The numerous above admonitions about keeping friendly relations with the franchisees, keeping informal communications open and active with each franchisee, personally visiting the franchisee's businesses, doing everything possible to meld the franchisor and all of the individual franchisees into a single competitive business offering the consuming public the best goods at the lowest prices are all contrary to limiting liability isolating the franchisor's principals.

The fact that the small franchisor's principals are in the thick of things makes it doubly important that they be educated concerning facts that might make them liable, i.e., misdisclosure, nondisclosure, failure to comply with registration laws, failure to make timely disclosures, etc., and that all possible adverse information be included in the UFOC. This goes back to the fact that most serious claims made against the franchisor's principals will be franchise sales claims of misdisclosure and nondisclosure. This is where most serious tort liability issues occur. Once a franchise is up and running, its relationship with the franchisor is primarily governed by the

franchise agreement. Again and again this paper's discussion of possible problems points to the franchisor's franchise sales process as being key to the franchise system's success.

J. **Taxes**

1. **State Sales Taxes**

a. Problem. The state tax administrator discovers ("I am shocked, shocked to learn that there is gambling at this establishment," Mayor Renault, 'Casablanca,') that your franchise system has licensed a trademark "located at" the franchised business in the state creating a "nexus" between the franchisor and the state sufficient to make the franchisor's business taxable by the state. Your franchisor receives a bill from a state other than its headquarters state for past-due sales taxes, i.e., thirteen years past due sales taxes with penalties and compounded interest equaling an incredibly large sum. (Such a letter was recently received by Kwik Kopy from Massachusetts.)

b. Treatment. This is a changing area of the law. That is particularly important to small franchisors as opposed to large franchisors. Large franchisors often have sufficient property in the subject state to unquestionably make them the subject to the state's taxes. It is the small franchisor who has no presence in the state other than some franchisees who is shocked to receive the tax bill. It is illustrative that Interstate Tax Corporation is currently sponsoring a three-day interstate tax planning seminar, a two-day sales and use tax update seminar, and a two-day advance interstate tax seminary, and a two-day advance sales and use seminar for total registration fees in the amount of $2,630. Attorneys are paying these prices because important changes are underway as hard-pressed state treasurers grab onto every dollar that leaves their state, be it in royalties, advertising payments, etc. The first thing to do upon getting such a letter you should contact the International Franchise Association Forum Committee on Franchising, and any other groups that have specialized knowledge concerning the issue. This is becoming a more likely problem because more and more states are aggressively seeking to tax franchisors.

c. Prevention. Since there is no statute of limitations if the business does not file a tax return, attempts to document that the royalties are for services and advertising delivered to the subject states rather than being trademark license fees. Consider filing income tax returns in states where the franchisor has employees, inventory, or other hard assets so you can get statutes of limitations running; and do whatever you can to prepare against receiving tax bills from other states where your franchisor's only contact is a franchise or perhaps even file a tax return there. Since this is a changing area of the law, you should try to keep up with the appropriate association committees. Further, you should advise your franchisor client that it may be a problem but that you do not have an answer for it. While this is not comforting advice, it is the most truthful advice that can be given at this time because increasingly aggressive state tax collectors are likely to be knocking on your client's door in the future.

2. State Franchise Taxes

a. Problem. Your franchisor never paid franchise taxes in the state in which it is litigating with the franchisee. The franchisee moves to bar the franchisor from obtaining relief on state causes of action.

b. Treatment. Pay the past-due taxes or rely only on federal causes of action in federal court or prove that the taxes are not due. Otherwise, the franchisee's motion might be granted. Duncan Donuts, Inc. v. Mercantile Ventures, Inc., 22 U.S.P.Q.2d 1721 (W.D. Tex. 1992) ("Plaintiff is a foreign corporation operating in Texas and is liable for the payment of franchise taxes…. and had failed to pay such taxes…. Accordingly, plaintiff Duncan Donuts, Inc. forfeited the right to sue or defend in this court on claims arising out of the transaction of business in Texas and arising under state law." Id., at 1721.)

c. Prevention. Since this is also a changing area of the law, you need to keep up with the appropriate association committees concerning how minimal a presence in a state must be to avoid being liable for these franchise taxes.

VIII. ATTORNEY LIABILITY

A. Generally

Although attorney liability is not the principal subject of this paper, no discussion with attorneys concerning how to deal with potential franchisor pitfalls is complete without it being briefly mentioned. The attorney malpractice standard is whether the attorney "exercised the skill, prudence and diligence that attorneys of ordinary skill and capacity in the community commonly possess and exercise in performing the tasks which they undertake." Rules have been proposed for certification of franchise practitioners. Fine, Model Standards for Recognition as a Specialist in Franchise Law, 4 Fran. L.J. Summer 1984 at 5 and have been discussed again more recently by the American Bar Association Forum Committee on Franchising. While they have not been adopted, they will be urged by the malpractice plaintiff's attorney as a standard against which your work for the franchisor should be judged. Because franchisors operate in many states with differing and changing laws, franchise attorneys must spend much unbillable time reading advance sheets, attending seminars, etc., to attain and retain a standard of competence and to keep abreast of developments as best they can.

It is essential that you know who your possible attackers may be.

B. The Potential Plaintiffs

1. Your Client. The perfect franchise agreement and UFOC does not and never will exist and would quickly become outdated if they ever did. Practical problems and technical and arguable violations of law will invariably creep into the franchisor's operations (which are implementing your documents) due to any ongoing business' own dynamic character and the many dynamic complex laws of numerous jurisdictions as discussed above. Whether you should have foreseen or prevented these problems can be argued by the same franchisors who previously instructed you to not run up a big legal bill.

A franchisor may claim that his failure to comply with the relevant franchise law, business opportunity law, and antitrust law, baby FTC Act, etc., was due to his attorney's malpractice. In Meinershagen et al v. Hughes & Luce et al, No. 89-13945-G (134th Jud. Dist. Dallas County, Texas, 1992) the jury verdict found that the franchisor's attorney committed malpractice in his representation of the franchisor but that his malpractice did not damage the franchisor due to the franchisor's other problems. Avoiding the cost and lost stomach lining of even a successful defense to such an action requires more unrequested memos to the file, letters confirming advice and legal preventative maintenance than other attorney/client relationships. The situation is similar to a public offering of securities where a premium is paid and paperwork is generated due to the attorney's own possible legal exposure.

2. One or More Franchisees. If you participate in any pre-sale negotiations by communicating with the potential franchise, or its attorney, banker, etc., you may be accused of having personally participated in the franchisor's alleged fraud or misrepresentations. If you prepare a uniform franchise offering circular or participate in preparing other such documents, you may be attacked for having participated in the preparation of an untruthful documents for your own profit upon which you knew franchisees would rely. Courtney v. Waring, 237 Cal. Rptr. 233, reh. denied, 191 Ca. 3d 1434 (1982), (Cal. App. 1987) "Plaintiffs allege that defendants negligently prepared a franchise prospectus which failed to disclose material information…. It is the attorney's knowledge regarding the purpose of his work [that prospective franchisees would rely on the disclosure document] which …. establishes a duty to those whose conduct has been influenced" Id. Cal. Rptr. at 239, Bus. Fran. Guide (CCH) at 17,812-3. This effectively applies the "due diligence" standard required of counsel in the preparation of securities disclosure documents to franchise counsel; See, Wulff, Is Franchisor Counsel Subject To Due Diligence Obligations? An Analytical Response, 4 Fran. L.J. Spring 1985 at 3.

Several state laws explicitly attempt to make the franchisor's attorney liable for any UFOC misdisclosure or other breach of the state's franchise act. "This obligation [of disclosure] is the independent obligation of all persons contributing to the disclosure including the franchisor and its counsel and accountant, to the extent of their professional involvement." Minn. S. Div. 1704 (M.S. 80C.04)(a)(1); "Every person who directly or indirectly controls a person liable under ….. [the subject act], every person in a firm so liable, every principal executive officer or director of a corporation so liable, every person occupying a similar status or performing similar functions, every employee of a person so liable who materially aides in the act of transgression constituting the violation, are also liable jointly and severally with and to the same extent of such person, unless the other person whose is so liable had not knowledge of or reasonable grounds to believe in the existence of the facts by reason of which the liability is alleged to exist." California Corporations Code §31302. Similar language is found in the franchise statutes of Illinois, Maryland, Michigan, New York, North Dakota, Oregon, Rhode Island, South Dakota and Wisconsin.

The several franchise and business opportunities laws' prohibition against a "material misrepresentation or omission" is similar to the language of §10(b)(5) that has been used to subject attorneys involved in the preparation of false or misleading securities offering materials to joint and several liability. SEC v. Frank, 388 F.2d 486 (2nd Cir. 1968); Reece, Attorneys Beware: Increased Liability for Providing Advice to Corporate Clients Issuing Securities, 20:3 Akron L. Rev. 519 (Winter 1987); Feit v. Lease Co. Data Processing Equip. Corp., 332 F. Supp.

544 (E.D. N.Y. 1971) ("a lawyer for the issuer plays a unique and pivotal role in the effective implementation of the securities laws. As a result, special duties are imposed on the lawyer…. the duty of the lawyer includes the obligation to exercise due diligence, including a reasonable inquiry, in connection with responsibilities he has voluntarily undertaken.") Thompson v. Vincent & Elkins, 859 S.W.2d 617 (Tex. App.--Houston [1st Dist.] 1993) (privity between plaintiff and defendant attorney not required in DTPA action).

Privity of contract is not always necessary to establish such a cause of action. Some states use a "balancing test" in considering "[t]he extent to which the transaction was intended to affect the plaintiff, the foreseeability of harm to him the degree of certainty that he suffered injury, the closeness of the connection between the conduct and the injury suffered, and the policy of preventing future harm." Lucas v. Hamm, 56 Cal. 2d 583, 15 Cal. Rptr. 821, 364 P.2d 685 (Cal. 1961); Fickett v. Superior Court of Pima County, 27 Ariz. App. 793, 558, P.2d 988 (Ariz. App. 1976). Further, intended third party beneficiaries may not require privity of contract.

3. Your Client's Officers and Directors. Upon being personally named in the franchisee's suit or upon being held individually liable, the franchisor's officers, directors, agents, etc., may assert that they believed you were looking out for their individual interests. What did you provably do to make sure they knew your only client was the corporate franchisor?

4. The Auditor and Your Client's Shareholders. Those innocuous annual audit letters that you sign and return to the auditor are relied on by the auditor in preparing its audit reports to the shareholders. If you are aware of a potential liability and do not disclose it to the auditor the auditor cannot disclose it to current and potential shareholders. If the undisclosed situation blows up to the detriment of the shareholders, the shareholders may sue the auditor and he may sue you. On the other hand, if you identify a possible survival-threatening cause of action against the franchisor that the statute of limitations may peacefully kill in six months and the auditor either publishes the matter or refuses to give a "going business" audit, this may wake up the potential plaintiff and cause a suit before the statute runs. Further, the audited financial statement is submitted with the UFOC to each state administrator. If the auditor publishes a problem, in his notes to the audit, the state administrator may pick it up and require rescission. If the auditor refuses to give a going business audit, the state administrator will impose an impound.

You can notify management that you can either (1) not respond to the audit request letter, (2) respond with an explanation of the issue (which will either lead to a 'not a going business" evaluation or disclosure of the matter in the audit's footnotes -- which will prevent the franchisor from obtaining state franchise registrations and will tell the franchisee to sue), or (3) respond but state that you are not disclosing all material threatened in litigation -- which will lead to no audit. The author is not aware of a good answer to this problem.

IX. CONCLUSION

Although the above list of potential pitfalls is exhausting, it is not by any means exhaustive. The number of topics could easily be doubled and still be faulted for omitting many demonstrably fatal pitfalls. Further, the treatment of each listed pitfall has been necessarily cursory to fit within the paper. The paper's primary goal is to identify the most likely potential

pitfalls to a competent business attorney so he or she, thus warned, will be more likely to anticipate and avoid such problems before they create the small franchisor's train wreck described at the beginning of this paper.

This paper's focus on potential franchising pitfalls should not obscure the fact that there is good, honest money to be made as a franchisor and as a franchise attorney. Since you will help your franchisor anticipate and avoid the above-listed potential pitfalls, your franchisor's odds of being successful will be improved because of your advice and counsel.