BEST PRACTICES
a Seminar for Franchisors
Legal Techniques

by

David E. Holmes

Northern California Office

555 Chorro Street, Suite D-2
San Luis Obispo, California 93405
Phone: 805.547.0697
Fax: 805.547.0716

Southern California Office

6621 Pacific Coast Hwy., Suite 250
Long Beach, California 90803
Phone: 562-596-0116
Fax: 562.596.0416

Please visit our website at www.HolmesLofstrom.com

We are what we repeatedly do. Excellence, then, is not an art, but a habit.

<u>Aristotle</u>

BEST PRACTICES
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OVERVIEW

WHAT'S BEEN DEMONSTRATED TO WORK IN FRANCHISING

The purpose of this presentation, and the accompanying materials, is to share with Franchisors some of our experience (and that of our most successful clients) as to what's been demonstrated to work in franchising, at least in the legal area. Our objective is to pass on those techniques that have been validated through demonstrated results to have been successful and to discuss some ways that those techniques can be incorporated in any franchise system.

We should probably begin by defining some of our terms. By "what's been demonstrated to work in franchising" we mean those techniques that have been shown, by practical experience, to help franchise systems avoid lawsuits and keep the Franchisor and Franchisees focused on building market share and profitability.

With few exceptions, we're not talking about untested provisions or techniques. Instead, we're basing our advice on over 20 years' experience in identifying the common factors that, from a legal standpoint, separate successful franchise systems from those that never fully achieve their potential.

While Mao Tse Tung may not have been completely right when he said "The only valid knowledge is direct experience," (after all, we can learn from the experiences of others) he did have a point. Therefore, what we've drawn on in preparing this paper is our direct knowledge and experience, as well as that of our clients.

You should also note that these suggestions, so far as we can tell, apply to all franchise systems irrespective of the industry involved, the stage of development of the Franchisor, competitive conditions and other factors. We believe that experience shows that all systems will benefit from implementation of the techniques outlined.

PRIMARY CONCEPT

THE FRANCHISE AGREEMENT (AND RELATED DOCUMENTS) AS THE CORE TOOL

With some simplification, it's been said that the Franchise Agreement is "the long pole in the tent" insofar as successful legal management of a franchise system is concerned. Experience demonstrates that a Franchisor with well-drafted

franchise agreements and supporting documentation is in a superior position to avoid lawsuits and to prevail if a lawsuit is threatened.

After all, franchising presents the Franchisor with a unique opportunity: In almost all cases, the Franchisor gets to write the contract and its content is rarely changed by the Franchisee. In effect, the Franchisor gets to write the rules for the relationship, something rarely experienced elsewhere in the business world. Given this opportunity, a Franchisor that fails to think carefully (and examine what successful Franchisors have already done) about how to structure the relationship to the best advantage of the Franchisor, as well as the long-term success of the system, is throwing away a tremendous business opportunity.

Later in this paper, we'll review some of the specific Franchise Agreement provisions you should consider in your system, along with other core documents, but for now the point is simply this: Your best investment from a legal standpoint is in creating strong documents that anticipate various problems that can occur in franchising and which will operate to deflect legal challenges by unsuccessful Franchisees.

With that overview, then, let's begin the work of examining what legal techniques work best in franchising.

We'll divide our discussion into three parts: Implementation - Initiating the Relationship, Implementation - Structuring the Relationship and Process - Managing the Relationship. (Although unintentional, this division may be appropriate since it seems that at least two-thirds of success in business relationships is based on implementation, not just great ideas.)

Along the way, we'll give examples of the kinds of techniques we've found work best and attach some discussions of certain areas in detail.

IMPLEMENTATION - INITIATING THE RELATIONSHIP

UFOC

From a legal standpoint, the first document involved in the relationship with the Franchisee is generally the UFOC. As you'd expect, this also represents the first opportunity for the Franchisor to set the tone for the relationship and to create effective legal tools for itself.

Three of these legal tools relate to the realities of franchising and business in general:

- Investment in a franchise carries with it no guarantee of success.

- No one can accurately estimate the total investment a Franchisee may be required to make (since no one can guarantee success.)

• Franchisors can't reliably estimate operating results for company owned units and certainly can't do so for franchised units over which they have no direct control.

While almost universally acknowledged by Franchisors, it's surprising how few UFOCs or Franchise Agreements take these realities and turn them into defensive tools for the Franchisor. When properly incorporated, these realities drive three separate sets of statements that should be found, in one form or another, in all UFOCs, which we've set out below:

Item 1 - No Guarantees

Finally, you should understand the following things: you're entering into a particular business which, incidentally, is franchised; entry into any business venture (whether franchised or not) necessarily involves some unavoidable risk of loss or failure; the purchase of a franchise may improve your chances for success, however, the purchase of a XYZ Franchise (or any other) franchise is a speculative investment and success cannot be guaranteed; significant investment beyond that outlined in this Offering Circular may be required to succeed; there exists no guaranty against possible loss or failure in this or any other business; and the most important factors in the success of any XYZ Franchise, including the one to be operated by you, are location and your personal operations, marketing, and other business skills and judgment.

Item 7 - No Assurances as to Total Capital Needed (Footnotes to Table)

(8) Additional Funds is an estimate of the funds needed to cover business (not personal) expenses during the first 3 months of operation of the franchised business. Your actual costs may be higher. You need capital to support on-going costs of your business, such as payroll, utilities, taxes, loan payments and other expenses, to the extent that business costs are not covered by revenues. New businesses (franchised or not) often have larger expenses than revenues. As with most businesses, your costs will depend on factors such as how much you follow our recommended systems and procedures, your technical, marketing and general business skills, local economic conditions, the local market for your business, competition, local cost factors and the sales levels achieved by you. The figures presented are only an estimate, however, and there is no guarantee that the amounts specified are adequate or that additional investment by you is not necessary during the 3 months of initial operation or afterwards. This is particularly true in our industry due to its rapidly developing nature and the fact that the sale of XYZ services and products using our business methods and procedures is a new and

evolving business concept, such methods and procedures, being new, do not (unlike some other businesses) have a demonstrated record of success, and the ability of businesses to effectively sell services and products through __________, as well as our (and your) ability to sell _______________, remains to be demonstrated, each of which factors can affect the funds needed to cover business expenses during the first 3 months of operation and which make any estimates very difficult to rely on. We do not furnish or authorize our salespersons or any other persons or entities to furnish estimates or otherwise as to the capital or other reserve funds necessary to reach "break-even" or any other financial position nor should you rely on any such estimates. The 3 month period from beginning business covers the time by which most Franchisees are fully in operation but does not necessarily mean that you will have reached "break-even" or any other financial position by that time. In addition, the estimates presented relate only to costs associated with the franchised business and do not cover any personal, "living" or other expenses you may have.

[Alternative example:]

(9) This estimates your initial startup expenses through the third month of operation. These figures are estimates and we cannot guarantee that you will not have additional expenses. No provision has been made for capital or other reserve funds necessary for you to reach “break-even” or any other financial position nor do any of these estimates include any finance charges, interest or debt service obligations. We suggest that you maintain investment capital reserves for access equipment and capacity expansion, marketing, and general operating during the development stage of your XYZ business. Your costs will depend on factors such as: how well you follow our methods and procedures; your management skill, experience and business acumen; local economic conditions; the local market for our product; the prevailing wage rate; competition; and the sales levels you achieve. We relied on 30 months of historical data, related to the ____________ business to compile these estimates. You should review these estimates carefully with a business advisor before making any decision to purchase the franchise.

Since costs can vary with each Franchise, it is strongly recommended that you (1) obtain, before purchasing a franchise or making any other expenditures or commitments, independent estimates from third-party vendors and your accountant of the costs which would apply to your proposed establishment and continued operation of an XYZ Franchise, (2) discuss with current XYZ Franchisees their economic experiences (including initial costs) in opening and operating an XYZ and (3) carefully evaluate the adequacy of your total financial reserves.

Although we make no estimates or representations regarding financial performance of an XYZ Franchise, we recommend that, in addition to the additional funds shown, you have sufficient personal savings and/or income so that you are self-sufficient and need not draw funds from the franchised XYZ business to support your "living" and other expenses during the initial start-up phase.

Item 19 - No Reliable Earnings Claims[1]

We don't furnish, or authorize our salespersons or anyone else to furnish, any oral or written information concerning the actual or potential sales, costs, earnings, income, profits, cash flows, or other results of a XYZ Franchise. Actual results vary from unit to unit and we cannot estimate the results for any particular XYZ Franchise.

In fact, we have no reliable way of estimating or projecting what the results will be for units owned and operated by us and we **certainly** have no way of knowing what results you'll achieve, since how well you might do depends on factors outside our control, including your general business ability, how closely you follow our system, your location, your competition and how good a salesperson/sales manager you are. We can't guarantee your success and we don't provide (or authorize) any sales, cost, income or other information or projections of any kind and you shouldn't rely on any projections or estimates of any type from anyone. This is particularly true in our industry due to its rapidly developing nature and the fact that the sale of ___________ services and products using our business methods and procedures is a new and evolving business concept, such methods and procedures, being new, do not (unlike some other businesses) have a demonstrated record of success, and the ability of businesses to effectively sell services and products through ___________, as well as our (and your) ability to sell ___________, remains to be demonstrated.

Remember that business realities are such that actual results will vary from unit to unit and we can't estimate or project the results for any XYZ Franchise, including the one you might operate and we can't guarantee you'll have similar results to any other XYZ Franchise. A new XYZ Franchisee's individual financial results will probably differ from the results of an established Franchisee (particularly during any start-up phase and probably afterwards as well) and results can vary widely from unit to unit. Perhaps most importantly, remember that past performance for any business is no guarantee of future results.

[1] Note that, as discussed below, this language would be supplemented if the Franchisor does make earnings claims, as we generally suggest they do.

> You should speak with current and/or past XYZ Franchisees to determine the suitability of an investment in a XYZ franchise and you should discuss your possible investment with an independent financial advisor, such as an accountant and/or attorney to assist you in making your decision.
>
> Our salespersons, agents, employees and officers (and all other personnel) are <u>not</u> authorized to make any claims or statements regarding prospects or chances of success, actual or potential sales, costs, earnings, income or profits of, or other financial matters regarding, an XYZ Franchise. <u>If, at any time, you believe that any promises, representations, projections, estimates (financial or otherwise), agreements or otherwise are or have been made to or with you that are not expressly set forth in writing in the Franchise Agreement or this Offering Circular, you must provide a written statement regarding those next to your signature on the Franchise Agreement. If any items of that type have been or are provided to you, they're inherently unreliable, they can't (and shouldn't) be relied on, we're not bound by them, and, if you do rely on any items of that type, you do so at your own risk. Please notify us in writing before you buy a franchise if any information or representations of that sort has been provided to you.</u>

In addition, Franchisors and their counsel need to remember that anti-fraud laws apply to franchising just like most of business and that <u>a material omission can be just as damaging as failing to properly address a specific line item in the UFOC</u>. When preparing the UFOC, you need to think about the industry and the potential investment from the Franchisees' side of the table. What are the potential problem areas in the business, where are the business challenges, what might go wrong? What's important in this business: site selection, customer convenience, low price, absence of competition, weather? Once you've identified these, then your job is simply to explain them (in the UFOC and possibly in the Franchise Agreement) to the prospective Franchisee, thereby protecting yourself.

For example, for some of our clients involved in businesses where direct sales ability is critical, we've used language like the following:

> Additionally, <u>the operation of an XYZ Franchise involves direct marketing and sales activity by you, as well as your supervision of salespersons working for you. The primary factors in your success will be (1) your personal effectiveness, personality and ability as a salesperson and as a supervisor of salespersons, (2) the degree to which you follow the XYZ System, including the marketing and operational systems prescribed and/or recommended by us and (3) your willingness to work smart and hard. Even if you do all of these things, there's no guarantee you'll be successful</u>. Finally, you should understand that entry into any business venture necessarily involves some unavoidable risk of loss or failure.

For another business involved in Internet marketing, a relatively new industry where "proof-of-concept" has not been completed, our client used the following language to help protect them:

> You should also understand that: the sale of Internet-related services and products using our business methods and procedures is a new and evolving business concept; such methods and procedures, being new, do not (unlike some other businesses) have a demonstrated record of success; the ability of businesses to effectively sell services and products through the Internet, as well as our (and your) ability to sell Internet-related advertising and other services to businesses and others, remains to be demonstrated; and for all of these reasons, along with the critical importance of your individual sales ability, your investment in a XYZ Franchise is a speculative investment with no guarantees of success and significant investment beyond that estimated in this Offering Circular may be necessary.

Finally, the UFOC can be used to "set the tone" in the area of system compliance, as this client did:

> You should understand that every detail of your XYZ Franchise will be important not only to you, but to us and to all XYZ Franchisees in order to: (a) develop and maintain high and uniform operating standards based on the concepts of consistency, reliability and professionalism; (b) increase the demand for the programs, products and services sold by XYZ Franchises; and (c) establish and maintain a reputation for offering uniform and high quality services exemplifying high client servicing standards, ethical business practices and integrity. A fundamental requirement of your joining and remaining part of the XYZ System will be your commitment to the operation of your XYZ Franchise in accordance with XYZ System Standards. During the term of the Franchise Agreement, you must, at all times, develop, maintain and operate your XYZ Franchise in compliance with all XYZ System Standards, as modified and supplemented by us in the future.

ITEM 19

We should say a few further things regarding Item 19, the part of the UFOC a Franchisor can use to set out financial results for operating units (franchised and/or company-owned.

We're generally fans of using an Item 19 "earnings claim" (assuming it's a positive marketing tool[2]) since one of the best possible defenses to the allegation by an unsuccessful Franchisee that "You gave me earnings claims," is to respond "You bet we did. And the State of California approved them."

[2] And, if it's not, we have to ask why you're franchising!

Finally, since the organization that sets the rules for the UFOC apparently plans to make earnings claims mandatory sometime in the future, wise Franchisors should probably prepare for the day when they'll be required to make this type of presentation.

STATEMENT OF PROSPECTIVE FRANCHISEE

One of our clients recently commented that, based on their real-life experiences, the Statement of Prospective Franchisee (an exhibit to the UFOC and signed at the same time as the Franchise Agreement) was, in their experience, a more effective "defense" tool for the Franchisor than the Franchise Agreement.

While we're not sure that's true, this document has been held by at least one Federal Court to eliminate all of a Franchisee's claims of pre-sale misrepresentations, etc. In any case, all intelligent Franchisors should use the following document or something very close to it (please see next page):

XYZ FRANCHISING, INC.
STATEMENT OF PROSPECTIVE FRANCHISEE

[Note: Dates and Answers Must Be Completed in the Prospective Franchisee's Own Handwriting.]

Since the Prospective Franchisee (also called "me," "our," "us," "we" and/or "I" in this document) and XYZ Franchising Inc. (also called the "Franchisor", "XYZ", "you" or "your") both have an interest in making sure that no misunderstandings exist between them, and to verify that no violations of law might have occurred, and understanding that the Franchisor is relying on the statements I/we make in this document, I/we assure the Franchisor as follows:

A. The following dates and information are true and correct:

1.	_____________, 20___ **Initials** ____________	The date of my/our first face-to-face meeting with any person to discuss the possible purchase of a XYZ Franchise.
2.	_____________, 20___ **Initials** ____________	The date on which I/we received a Uniform Franchise Offering Circular about a XYZ Franchise.
3.	_____________, 20___ **Initials** ____________	The date when I/we received a fully completed copy (other than signatures) of the Franchise Agreement and all other documents I/we later signed.
4.	_____________, 20___ **Initials** ____________	The earliest date on which I/we signed the Franchise Agreement or any other binding document (not including any Letter or other Acknowledgment of Receipt.)
5.	_____________, 20___ **Initials** ____________	The earliest date on which I/we delivered cash, check or other consideration to the Franchisor, or any other person or company.

B. Representations and Other Matters:

1. No oral, written, visual or other promises, agreements, commitments, representations, understandings, "side deals," options, rights-of-first-refusal or otherwise of any type (collectively, the "representations"), including, but not limited to, any which expanded upon or were inconsistent with the Offering Circular, the Franchise Agreement or any other written documents, have been made to or with me/us with respect to any matter (including, but not limited to, advertising, marketing, site location and/or development, operational, marketing or administrative assistance, exclusive rights or exclusive or protected territory or otherwise) nor have I/we relied in any way on any such representations, except as expressly set forth in the Franchise Agreement or a written Addendum thereto signed by the Prospective Franchisee and the Franchisor, except as follows: ____.
(If none, the Prospective Franchisee should write NONE in his/her/their own handwriting.)

Prospective Franchisee's Initials: ____________________________________

2. No oral, written, visual or other claim, guarantee or representation (including, but not limited to, charts, tables, spreadsheets or mathematical calculations to demonstrate actual or possible results based on a combination of variables, such as multiples of price and quantity to reflect gross sales, or otherwise), which stated or suggested any specific level or range of actual or potential sales, costs, income, expenses, profits, cash flow, tax effects or otherwise (or from which such items might be ascertained), from franchised or non-franchised units, was made to me/us by franchisor, its affiliates or agents/representatives, nor have I/we relied in any way on any such, except for information (if any) expressly set forth in Item 19 of the Franchisor's Offering Circular (or an exhibit referred to therein), except as follows:
   ____.
   (If none, the Prospective Franchisee should write NONE in his/her/their own handwriting.)

   Prospective Franchisee's Initials: ______________________________

3. No contingency, prerequisite, reservation or otherwise exists with respect to any matter (including, but not limited to, the Prospective Franchisee obtaining any financing, the Prospective Franchisee's selection, purchase, lease or otherwise of a location, any operational matters or otherwise) or the Prospective Franchisee fully performing any of the Prospective Franchisee's obligations, nor is the Prospective Franchisee relying on the Franchisor or any other entity to provide or arrange financing of any type, nor have I/we relied in any way on such, except as expressly set forth in the Franchise Agreement, or a written Addendum thereto signed by the Prospective Franchisee and the Franchisor, except as follows:
   ____.
   (If none, the Prospective Franchisee should write NONE in his/her/their own handwriting.)

   Prospective Franchisee's Initials: ______________________________

4. The individuals signing for the "Prospective Franchisee" constitute all of the executive officers, partners, shareholders, investors and/or principals of the Prospective Franchisee and each of such individuals has received the Uniform Franchise Offering Circular and all exhibits and carefully read, discussed, understands and agrees to the Franchise Agreement, each written Addendum and any Personal Guarantees.

   Prospective Franchisee's Initials: ______________________________

5. I/we have had an opportunity to consult with an independent professional advisor, such as an attorney or accountant, prior to signing any binding documents or paying any sums, and the Franchisor has strongly recommended that I/we obtain such independent professional advice. I/we have also been strongly advised by the Franchisor to discuss my/our proposed purchase of, or investment in, a XYZ Franchise with existing XYZ Franchisees prior to signing any binding documents or paying any sums and I/we have been supplied with a list of existing XYZ Franchisees.

   Prospective Franchisee's Initials: ______________________________

6. I confirm that, as advised, I've spoken with past and/or existing XYZ Franchisees, and that I made the decision as to which, and how many, XYZ Franchisees to speak with, *although I understand that as a new Franchise System, few, if any, Franchisees are available to speak with.*

   Prospective Franchisee's Initials: ______________________________

7. I/we understand that: entry into any business venture necessarily involves some unavoidable risk of loss or failure, the purchase of a XYZ Franchise (or any other) is a speculative investment, an investment beyond that outlined in the Offering Circular may be required to succeed, there exists no guaranty against possible loss or failure in this or any other business and the most important factors in the success of any XYZ Franchise, including the one to be operated by me/us, are my/our personal business, marketing, sales, management, judgment and other skills.

Prospective Franchisee's Initials: ________________________________

If there are any matters inconsistent with the statements in this document, or if anyone has suggested that I sign this document without all of its statements being true, correct and complete, I/we will (a) **immediately** inform the Franchisor's attorney (toll free 1-888-547-0697) and an officer of the Franchisor and (b) make a written statement regarding such next to my signature below so that the Franchisor may address and resolve any such issue(s) at this time and before either party goes forward.

I/we understand and agree that the Franchisor does not furnish or endorse, or authorize its salespersons or others to furnish or endorse, any oral, written or other information concerning actual or potential sales, costs, income, expenses, profits, cash flow, tax effects or otherwise (or from which such items might be ascertained), from franchised or non-franchised units, that such information (if any) not expressly set forth in Item 19 of the Franchisor's Offering Circular (or an exhibit referred to therein) is not reliable and that I/we have not relied on it, that no such results can be assured or estimated and that actual results will vary from unit to unit, Franchise to Franchise, and may vary significantly.

Prospective Franchisee's Initials: ________________________________

I/we understand and agree to all of the foregoing and represent and warrant that all of the above statements are true, correct and complete.

Date: __________________________

PROSPECTIVE FRANCHISEE (Individual)

____
Signature

____
Printed Name

____
Signature

____
Printed Name

PROSPECTIVE FRANCHISEE (Corp., LLC or Partnership) - Must be accompanied by appropriate personal guarantee(s)

____
Legal Name of Entity

a________________________ _______________________________________
Jurisdiction of Formation Corporation, LLC or Partnership

By: __________________________________
Name

____
Signature

Title: __________________________________

PRINCIPALS

____
____

____
____

All of the above is true, correct and complete to the best of my knowledge:

____
Franchise Marketing Representative

Reviewed by: XYZ Franchising, Inc.

_________________________________ ________________________________
President Franchise Agreement Number

IMPLEMENTATION - STRUCTURING THE RELATIONSHIP

DEAL POINTS

General

By "deal points" we mean those elements of a franchise business relationship that have central significance for the business involved and have the potential to present "land mines" for unwary Franchisors.

Here, the concern is not so much that the unsuccessful Franchisee will attempt to walk away from his or her commitments (although that's always a possibility), but that the "deal" will turn out to be something different from what the Franchisor thought it was.

In most cases, that type of scenario can be avoided by carefully thinking through what you want to establish as the fundamental elements of the business relationship and examining where Franchisors and Franchisees have gotten "off track" in the past. Once these have been identified, the appropriate language can find its way into the Franchise Agreement and UFOC to clarify exactly what the business relationship is.

Let's take some examples:

System Expansion (Territorial "Rights")

One excellent example of this process is in the area of what territorial rights a Franchisee is granted or may be given by the law in the absence of clear Franchise Agreement provisions and the degree to which the Franchisor's legitimate opportunities to expand the system may be thwarted.

We see a number of instances where Franchisors have either (1) failed to think through how their system might grow and thereby failed to provide for appropriate rights for the Franchisor to access additional markets, locations, etc. or (2) failed to realize that Franchisees will react with fear to any additional units (or even non-traditional outlets) in an area and that at least some courts will, under a vague "covenant of good faith and fair dealing," impose restrictions on the Franchisor that the parties would never have agreed to if the matter had been appropriately analyzed at the beginning.

The remedy for this problem is twofold:

First, the Franchisor needs to carefully think about what related businesses it might want to enter in the future, the additional business fields in which it might want to use the trademark, what alternate channels of distribution it could utilize and, at base, exactly what business opportunity it's selling the prospective Franchisee and to reserve all other possible opportunities for itself. For example, what about

Internet sales, mail-order, “national” accounts, frozen product in supermarkets, kiosks, etc.?

Second, the cases decided by the courts in this area make it clear that if the Franchisor wants to limit the Franchisee’s rights and preserve the Franchisor’s ability to expand, it needs to have clear and explicit language in the Franchise Agreement to that effect.

Amazingly enough, some cases exist in which the Franchisor expressly said that it was not awarding exclusive territories and the courts still limited the Franchisor’s ability to put another unit at a location where the Franchisee claimed it would adversely affect his business! At the same time, the courts have also been clear that if the appropriate language is in the Franchise Agreement (and UFOC) the Franchisor can reserve the right to expand in whatever way it believes appropriate.

For further discussion of this area, see the attached excerpt from one of our recent newsletters entitled “How to Avoid Unlimited “Exclusive Territories” Imposed by a Court.”

Agreement Provisions

Here we turn to a number of provisions that Franchisors have found useful in structuring the franchise relationship in the ways they think appropriate.

While there’s neither the room nor the time to go into all of these provisions in detail, we’ll mention what we think are some of the more important areas for examination and give you what we believe are the directions toward which we believe intelligent Franchisors are moving. In addition, maybe these provisions will help you to think “outside the box” and starting considering what other provisions would help your system.

Advertising Funds

A recent case, in which the Franchisor was held liable for almost $600 million dollars for alleged mismanagement of its Advertising Fund, highlights the necessity for provisions in the Franchise Agreement granting the Franchisor essentially unlimited management discretion in running the Advertising Fund and avoiding treatment as a “fiduciary.” This topic is expanded on in the attachment entitled “Meineke - $591,000,000 Judgment Warns Franchisors to Revisit Advertising Fund Provisions and Practices.” The conclusion is that with the right language in the Franchise Agreement, the chances of this type of horror story being applied to your system are largely eliminated.

Royalty Reductions for Superior Performance

One of our clients considers the application of system standards and the Franchisee’s compliance with those standards to be so important that it is willing to

create an economic incentive for Franchisees to achieve high system compliance scores. It does this in the following way:

Franchisees are regularly audited for system compliance and an objective score assigned. This is then compared to the scores achieved by company-owned stores (not franchised stores generally, since this may result in a declining spiral of mediocrity!) If the Franchisee scores higher than a specified percentage of the company-owned stores (and is in compliance with all of his other obligations), he is eligible for a one-year royalty reduction.

Obviously, this approach is based on a business judgment that if a store is clean, carries all required items, has courteous and knowledgeable staff, etc., the Franchisor will spend less time and money chasing compliance issues and the store is likely to generate higher revenues on which royalties are based.

Equally obviously, the numbers selected should be such that even after such a royalty rebate, the Franchisor is covering expenses and receiving a reasonable return on equity.

Site Selection Responsibility

For systems where a specific retail site is involved, appropriate clauses should always be inserted in the Franchise Agreement making it clear that even though the Franchisor may assist in the site selection process and their consent is required for any site, the Franchisee bears ultimate responsibility for the selection of the site and cannot sue the Franchisor on a theory that "I relied on you to pick the right site for me."

These provisions should be supported by a separate Site Selection Acknowledgment form signed at the time the site is identified and approved.

Real Estate Control

For businesses where the site has significant value, the Franchise Agreement should also provide that the Franchisor may, at its option, take over the lease at any time, subleasing the property to the Franchisee until and unless he/she is in default, at which time the Franchisor can take over possession and operate the business for its own account.

Dispute Resolution Provisions

Although few Franchisor/Franchisee disputes reach the stage of actual litigation, a well-drafted Franchise Agreement works to prevent litigation (through, in part, the strength of the dispute resolution provisions) and to prevail if litigation erupts.

Without attempting to lay out all of the appropriate provisions in detail, the following can serve as a beginning checklist to determine if your Franchise

Agreement contains the types of provisions that experience has found create a reasonable environment for the resolution of disputes:

- Mediation
- Mandatory binding arbitration
- Waiver of jury trial
- Limitation of damages
- Franchisee to give Franchisor prior notice of claims and opportunity to cure
- Shortened statute of limitations
- No liability for Franchisor withholding consent
- No attorney's fees
- California law not chosen to apply to the relationship
- Extensive merger and integration clause

What's critical to understand is that each of these provisions has been demonstrated to be of highly significant value in eliminating Franchisee claims and creating an environment in which lawsuits just aren't filed against the Franchisor, let alone won by the Franchisee. Leaving out any one of them can put a Franchisor in an uncomfortable position when a dispute with a Franchisee pops up.

Releases

Releases are the Franchisor's friend. Often its best friend!

By requiring the Franchisee to provide a general release of all known and unknown claims at various points in the relationship, the Franchisor "washes clean" of any prior problems, whether related to the original franchise sale, the ongoing relationship up to the time of the release, or otherwise.

Points at which we suggest the Franchisor receive a release include the following:

- Assignment
- Renewal
- Repurchase
- Relocation
- Award of additional franchise (second unit, etc.)

• Any other situation where the Franchisee is receiving "consideration" from the Franchisor (*e.g.* royalty vacation, forgiveness of defaults, etc.)

We also utilize releases in connection with various exit strategies, as outlined below.

Exit Strategies

Here we're talking about appropriate provisions for the Franchisor to cause the exit of the Franchisee from the System (typically due to underperformance), the right of the Franchisor to purchase the unit, termination of the franchise by the Franchisor on return of the initial franchise fee, and releases on default.

Let's discuss these in detail:

Performance Standard

No franchise system should have to "carry" poorly performing Franchisees. Poor economic performance is generally related to system non-compliance and hurts all members of the system, including other Franchisees.

The fair way to handle this problem is a clause that does the following:

- Puts the Franchisee on notice of poor sales performance.
- Applies a performance standard rationally related to similar franchised units.
- Gives the Franchisee a reasonable period to correct the situation.
- Commits the Franchisor to assist the Franchisee in the correction process.
- Gives the Franchisee a reasonable period to sell the business if the problem can't be corrected.
- Otherwise terminates the franchise.

Purchase of the Unit

Most Franchise Agreements give the Franchisor a right-of-first-refusal if the Franchisee plans to sell the unit. But the Franchisor needs more. Sometimes, the best solution to a problem Franchisee is simply to buy him or her out. What's used is a clause that requires the Franchisee to accept a reasonable, "fair market value" offer with any disputes to be resolved by independent appraisal.

Termination on Returning the Initial Franchise Fee

In other situations, the Franchisor may have no interest in purchasing the Franchisees' business but it's become obvious that the relationship is "broken"

and the parties need to go their separate ways. In this case, the "friendly divorce" provision is particularly useful.

Under this type of provision, the Franchisor, at its option, returns the Initial Franchise Fee to the Franchisee, who thereupon takes down all identification relating to the franchise, returns all proprietary materials, etc. but is allowed to remain in business (unlike the provision discussed above, the Franchisee will not be bound by any post-term non-compete provision.) This type of clause allows the Franchisor to remove a Franchisee from the system without taking on responsibility for attempting to recover a business that the Franchisee may have driven into the ground.

Releases on Default

In each of the preceding cases, the Franchisee signs a release on repurchase, receipt of the initial franchise fee, etc. This clause is somewhat different in that it gives the Franchisor the option to require the Franchisee to sign a release in exchange for the Franchisor waiving its rights to collect the royalties that would have been paid in the period after the Franchisee's termination.

This type of clause is particularly useful where the Franchisee has committed a default (*e.g.* failing to pay royalties) and is threatening suit if the Franchisor terminates. The Franchisor's "trump card" is to say "Fine. I hereby waive my right to certain damages based on your default and you have to give me a release in exchange."

PROCESS - MANAGING THE RELATIONSHIP

After all of these details, some final notes are in order regarding ongoing management of the franchise system from a legal standpoint.

EDUCATION

Successful Franchisors understand the necessity for good initial training, as well as ongoing training, for their Franchisees, store managers, etc. The same principles apply to the Franchisor with respect to the legal aspects of franchising.

"Franchise Law 101" is a one-half day session detailing the basic legal rules that apply to franchising, with an emphasis on how the law affects the franchise award process. Having us come in and present this class seems to pay real dividends in reduced instances of inadvertent franchise law violations, lower legal expenses, etc.

ADMINISTRATIVE SUPPORT

Franchise rules are complex and changing. This can present a challenge to the Franchisor where compliance with the rules is often delegated to a junior staff member without legal training or even significant experience in franchising.

A solution to this problem may be to have one of our paralegals assist you in setting up the systems to assure legal compliance and serve as a resource for occasional questions. At that point, your staff individual can confidently handle most issues related to franchise sales and related document compliance.

CONSTANT REFINEMENT

Franchisors constantly improve their training systems, marketing, products, etc. The same thing needs to be done with franchise documents, since the competitive and legal consequences of having out-of-date documents or ones that fail to reflect state-of-the-art approaches put the Franchisor at a real competitive disadvantage.

FRANCHISEE PARTICIPATION

Finally, at appropriate points, Franchisees need to be brought into the equation.

We have the chance, as professionals in the field and with a large number of Franchisor clients, to see commonalities among successful franchise systems. Perhaps the strongest commonality is a team spirit, in which the Franchisor and the Franchisees are working towards a common goal, each bringing unique resources to the table.

It's probably fair to say that no franchise system succeeds without strong leadership from the Franchisor. It's equally true that franchise systems have a greater opportunity to establish and maintain market share when they work together. In that sense, as many others, franchising is no different than other businesses.

HOW TO AVOID UNLIMITED "EXCLUSIVE TERRITORIES" IMPOSED BY A COURT

One of the long-term areas of potential disagreement in franchising concerns "encroachment" or the ability of a Franchisor to place company-owned or franchised units in a market where a franchised location already exists.

Obviously, viewpoints differ as to the impact of introduction of a new unit in the general vicinity of an existing franchised unit. Franchisees, understandably focusing on the impact on their individual unit rather than on the growth of the entire system, will be concerned that the introduction of a new unit in their marketing area will reduce sales and lower profitability. Since the Franchisee is ultimately concerned with the bottom line on a unit-by-unit basis, and the Franchisor may be

primarily compensated by a percentage of gross without a direct connection to per unit profitability, the Franchisee may feel that the Franchisor is enhancing its system-wide revenues at the expense of individual Franchisees who may be impacted by the introduction of new units (or alternative channels of distribution) in their marketing area. The fact that the Franchisor may also be receiving additional income, in the form of initial franchise fees from new franchise units in the area, can be an additional source of tension between the Franchisee and the Franchisor.

At the same time, the Franchisor may see legitimate benefits for the entire system from the introduction of additional units. These can include:

- Increased market share/presence for the franchise system as a whole.

- Acquisition of desirable locations for the system and exclusion of competitors from those locations.

- Improved customer awareness and other benefits (including convenience) to customers.

- Increased funds available for local and/or national co-operative advertising.

- Economies of scale with suppliers, etc.

- Leadership for the franchise system in establishing new markets and means of distribution and placing all units in a superior position with respect to competitors.

Obviously, the impact of a particular new unit or means of distribution being introduced into a market will vary on a case-by-case basis. Does the placement of a new donut and coffee franchise at the American Airlines Terminal at LAX, or inside Caesar's Palace, was what really reduced sales at a unit located on a street corner three-quarters of a mile away? Will the introduction of frozen waffles, bearing the system's trademark, in the local supermarket really impact business at the local pancake house and will the impact be positive or negative?

Putting to one side all of these real-life business variables, when Franchisees believe that introduction of a new unit will adversely affect their profitability, they will often try to use a legal theory, known as the "covenant of good faith and fair dealing" to limit the Franchisor's ability to introduce new units, or alternative channels of distribution, into the area. In essence, this theory holds that the Franchisor may have a duty to not do any thing that would interfere with the Franchisee's ability to enjoy the benefits of the Franchise Agreement.

While most courts have rejected the application of this theory to encroachment situations, a recent Federal appeals court case arising in California (In re Vylene, CCH Business Franchise Guide ¶ 10,981, 1996) has held that the placement of a competing restaurant within 1.5 miles of a Franchisee's Naugles unit could have violated the covenant of good faith and fair dealing even though the Franchisee did not have any rights to an exclusive territory (and had certainly not paid for one) under the Franchiser Agreement. The case has at least two serious

problems with it:

First, the court's opinion ignores a series of cases (dealing primarily with the Burger King system) that have not applied the covenant of good faith and fair dealing to restrict a Franchisor's ability to place additional units in a Franchisee's market.

Second, the implied covenant, by its very nature, is vague and provides no meaningful guidance for business people. For example, if a Franchisee is given a one mile radius and the placement of a unit at 1.2 miles might violate the implied covenant, what about a unit at 1.5 miles, or 3 miles, etc.? What about the situation where the new unit is 1.1 miles away on the map, but the nearest route be road takes 2.5 miles due to an intervening freeway or river? Essentially, imposing this vague "good faith and fair dealing" standard leaves the Franchisee and Franchisor without any guidance as to how they are to manage their developing relationship.

Fortunately, Vylene and other cases like it (such as Scheck v. Burger King) can be relatively easily handled through intelligent drafting of the Franchise Agreement. Whether the franchise is drafted for a "spot" location (with no exclusivity within a radius) or if a radius is given, the Franchise Agreement should make it clear that the Franchisor has the entirely unrestricted right to place other units (or alternative channels of distribution) wherever it wishes, outside any radius granted and irrespective of the distance from any existing unit or the number of units in an area.

Although the drafting of the "Territory" clause in any Franchise Agreement is one of the more challenging and creative tasks for a franchise lawyer, and each clause must be different depending on the type of business involved and the expansion strategy of the Franchisor, it's probably safe to say that almost every Franchise Agreement should, at some point, contain a clause with wording similar to the following:

> You understand and agree that, except as expressly described above, you do not have any "exclusive territory" or any "exclusive," "protected" or "reserved" territorial or similar rights and there is, and will be, no limitation on our rights to locate and/or consent to the location of other XYZ units or other distribution facilities of any type at any location, regardless of the distance from, impact on, or vicinity of, your XYZ unit or the number of XYZ units in an area or market.

According to our clients, language similar to the above, in conjunction with related language supporting the Franchisor's position, has not raised any significant marketing hurdles in connection with selling franchises. In addition, we've been successful in inserting language in Franchise Agreements specifically negating the implied covenant of good faith and fair dealing. All of these steps will be useful to Franchisors in avoiding results such as that in the Vylene case.

We strongly recommend that Franchisors review their current Franchise Agreements and UFOCs to verify that their existing language does not leave

them exposed to having an exclusive territory imposed on them in a way inconsistent with their marketing plans and strategy for the long-term development of the system.

MEINEKE - $591,000,000 JUDGMENT WARNS FRANCHISORS TO REVISIT ADVERTISING FUND PROVISIONS AND PRACTICES

Among the many competitive benefits associated with doing business in a franchised format, the enhanced ability of franchised units to market their products and services through the combined power of a Marketing Fund may be foremost.

Top-of-mind awareness, enhanced recognition factors, and access to particularly effective media and marketing program design are all basic business drivers in establishing the franchise relationship and (hopefully) giving members of a franchised system significant competitive business advantages over competitors. Obviously, a Franchisee who belongs to a franchise system that has a multi-million dollar advertising budget will have a significant advantage when placed in competition with other business that don't enjoy access to that level of marketing resources.

Given the central importance of marketing funds in franchising from a business standpoint, the literature (and case law) on the subject is surprising in its lack of treatment of this area. [A recent multi-volume treatise on franchising, in fact, devotes less than a page to considerations involved in drafting that part of the Franchise Agreement concerned with national or regional marketing funds and their administration.]

Now that may change, in part as the result of a recent case in which a Franchisor was sued (and lost) over its management of its advertising fund. Due to the importance of this case, and the fact that its results should be relatively easily avoided by most Franchisors through intelligent management and proper marketing fund provisions in their franchise agreements, we've decided to devote a major portion of this newsletter to this topic. [Many of our suggestions are drawn from a talk David gave for the IFA's Legal Symposium on the subject of legal aspects of advertising funds. Copies of his full materials (which cover more than just the Meineke case), and the franchise agreement provision he recommends, can be obtained by phoning our offices or requesting a copy by e-mail.]

The recent and much discussed case of Broussard v. Meineke, (U. S. Dist. Ct, Western Dist. of North Carolina, 3:94CV225-P, Memorandum of Decision filed March 6, 1997 - CCH Bus. Fran. Guide ¶11,125) raises significant potential problems for Franchisors, by applying a fiduciary standard to the Franchisor's management of the marketing fund. As many readers may know, the fiduciary standard is one of the highest that the law can apply, requiring the Franchisor to place the Franchisee's interests before those of the Franchisor and creating a vague, not-based-on-contract, standard that may be very difficult to apply to real life issues and questions that arise in the management of a marketing fund. As

you'll see, franchisors can probably avoid application of this standard through wise drafting of their franchise agreements and intelligent management of the marketing fund. But first, let's see what Meineke was all about.

In the Meineke case, evidence was presented that the Franchise Agreements obligated Meineke to purchase and place advertising for the Franchisees in exchange for their franchise royalty fees (not in exchange for separate marketing contributions) and that Meineke had told its Franchisees that the marketing fund was a trust fund which was spent exclusively for the benefit of the Franchisees.

As the evidence at the trial showed, Meineke breached its obligations under the Franchise Agreements and its fiduciary duties to the Franchisees when it created an entity to perform these tasks and took fees and commissions from the advertising account, negotiated volume discounts for advertising and took these discounts for itself, purchased superfluous advertising to generate fees, and used the advertising fund for improper purposes, such as settling a lawsuit, paying Meineke's business expenses and using such advertising funds to advertise to attract new Franchisees.

Perhaps most significantly, evidence was presented that (among other things) Meineke decided to use the marketing fund as a source of revenue, doing such things as breaking a contract with an existing outside advertising agency (and thereafter paying funds from the marketing fund to settle the resulting lawsuit), placed advertising itself while charging the marketing fund for such services (which had previously been rendered at no charge); chose advertising media so as to maximize the fees it could charge rather than choosing media on the basis of how it would serve the long-term interests of the chain; secured volume discounts but kept those discounts for itself; and used the advertising fund to attract new Franchisees rather than to enhance retail sales and concealed misappropriations of the funds. On this basis, the Court found that the jury's findings of fraud, breach of fiduciary duty, interference with contract and deceptive trade practices were fully supported by the evidence.

From a franchise sales standpoint, Meineke's exposure was based, in large part, on how the franchise sales process was handled. Perhaps "mishandled" would be the better word. Here's what happened:

Meineke had been advised by the then attorneys that they should videotape the closing for each franchise sale. [This is generally a bad idea, and not something we recommend, for reasons that will become painfully clear in a few more lines.] During the closings, the prospective Franchisees were apparently told by franchise sales personnel that the marketing fund was a "trust" and that Meineke "did not make any money off it."

In fact, this part of the franchise sales presentation was directly contrary to reality, since Meineke (and related companies) received reimbursement for expenses, received commission income and otherwise received revenues and positive income through their involvement with the advertising fund.

Clearly, whatever one thinks of the way Meineke handled the advertising fund, the franchise marketing people were, intentionally or not, out of phase with how the fund was being managed. Part of the lesson for Franchisors from the Meineke case is the ongoing need for top management to be monitoring the franchise sales process and the assure that the "script" being used, and actual presentations, accurately describe the way the franchise system is being operated.

[By the way, in over 20 years experience in franchising, we're unaware of any other Franchisor that handles its marketing fund in the way that Meineke apparently did. Clearly, this type of behavior was not "center of the bell curve" for most Franchisors.]

Based on the evidence of how Meineke had handled the fund, <u>and particularly given Meineke's representations that the fund was a "trust,"</u> the jury found the defendants liable for breach of contract, breach of fiduciary duty, fraud and various other torts and awarded damages on a class-wide basis. Interestingly enough, the Court (not merely the jury) found that Meineke's conduct rose to the level of "unfair and deceptive trade practices."

Interestingly enough, Meineke's legal exposure (and the potential damage award would have been even <u>greater</u>) if Meineke had failed to obtain releases from its Franchisees in the course of assignments, renewals and the introduction of a new dealer program. Many of these releases were upheld by the court and served to reduce the damages awarded.

Finally, Meineke's franchise agreement apparently failed to provide for arbitration, waiver of jury trial, limitation of damages, waiver of punitive damages or other provisions typical in "state of the art" franchise agreements being drafted today.

Franchisors with existing franchise agreements that have provisions which fail to take into account the Meineke case, even if the franchise agreements were revised or drafted as recently as a few months ago, should have their agreements revised to provide improved protection in light of what happened to Meineke.

Clearly, if the findings of the jury and the Court are justified, <u>Meineke</u> presents an unusual fact situation in a number of areas:

- A Franchisor being obligated to purchase and place advertising using royalty fees rather than marketing fund contributions.

- A Franchisor <u>expressly and repeatedly representing that the marketing fund was a trust fund</u> from which it derived no profit.

- A Franchisor expressly holding itself out as a fiduciary with respect to the marketing fund.

- A breach of that fiduciary duty by setting up an in-house agency to purchase and place advertising and then charging additional fees and commissions for tasks the Franchisor was already obligated to perform for the royalties paid.

- A further breach of that fiduciary duty by breaking a contract with an outside advertising agency and paying settlement amounts out of the marketing fund.

- A Franchisor purchasing and placing advertising based on the generation of fees rather than benefits to the retail outlets.

- A Franchisor using funds from the marketing fund to pay its business expenses.

- A Franchisor taking interest earned on marketing fund deposits and using them for its own benefit.

- A Franchisor keeping volume discounts for its own benefit.

- A Franchisor using the marketing fund to attract new Franchisees rather than build retail volume.

- A Franchisor making false and misleading statements to Franchisees to conceal its actions.

Based on these findings, the lessons for Franchisors seem clear:

- Don't design a franchise system in which it can be argued that the Franchisor has an obligation to create, purchase or place advertising (or other marketing services/material) using anything other than contributions to the marketing fund (and certainly not using royalty payments!)

- Don't represent that the marketing fund is in the nature of a trust or that the Franchisor will act as a fiduciary, expressly disclaim such "fiduciary" or "trust" obligations in the Franchise Agreement and monitor the sales process (and educate all sales and operations personnel) accordingly.

- On the basis that clear contract provisions leave little room for erroneous expectations or later dispute, and significantly reduce the Franchisor's potential exposure, the Franchise Agreement should expressly provide that:

- The Franchisor may create and use in-house advertising agencies and pay them commissions out of the marketing fund.

- The Franchisor may reimburse itself for reasonable administrative, accounting, legal and other expenses.

- Interest earned on the marketing fund may be retained by the Franchisor.

- A portion of advertisements funded by the Marketing Fund may refer to franchise opportunities.

- The Franchise Agreement should also provide for appropriate dispute resolution provisions, including:

- Mandatory mediation and binding arbitration.

- Waiver of jury trial.

- Waiver of attorney's fees.

- Limitation of damages.

- Shortened periods to bring claims.

- Choice of venue at the Franchisor's headquarters.

- Obtain releases whenever possible (renewal, transfer, purchase of additional franchise, relocation, forgiveness of debt or delay in performance of obligations, etc.)

Franchise agreements that fail to include the types of provisions mentioned above should be revised. Such changes will provide significantly improved protection, both against Meineke-type claims, as well as others.

Finally, from a business standpoint, all Franchisors need to think carefully about how they manage their marketing funds and whether or not any of the practices they engage in might be subject to legal attack. Intelligent management, a well-drafted franchise agreement and involvement of representative franchisees in an advisory council will go a long way to assuring that the Meineke experience is not repeated in your franchise system.