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AVOIDING LAWSUITS A Business and Legal Guide for Franchisors

by

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INTRODUCTION

First of all, let me tell you what I'm going to be talking with you about: I'm going to be sharing my observations, gathered over 20 years in franchising, about what causes lawsuits and how to avoid them. Whether you or I think that the legal environment of franchising is desirable or makes sense or is even the way you and I might design the rules, isn't really important. What's important is to understand how disputes come about and what we can do to (1) avoid them resulting in lawsuits and (2) reduce or eliminate their effects when they do occur.

BUSINESS AND LEGAL CONSIDERATIONS

As the title of this paper indicates, I believe that an **integrated approach to the business and legal environment** of franchising is the only one likely to result in a Franchisor being successful in avoiding (or at least minimizing) lawsuits.

Concentration on just the business factors in franchising may be successful in maximizing the number of happy and successful Franchisees, but can leave the Franchisor exposed to legal entanglements with the few Franchisees that (inevitably) won't be successful in any system.

At the same time, the best legal procedures in the world, and the most tightly drafted contract, will only provide some insulation against legal attacks. If the business has not been structured properly or an unhealthy relationship develops with Franchisees, the good news may be that you'll have some great defenses in court, while the bad news is that you'll have unsuccessful, unhappy, embittered Franchisees taking you to court in the first place.

Understanding that **both legal and business outlooks have to be kept in mind**, and in a well-run franchise system they reinforce and supplement each other, let's take a look at what over 20 years experience in franchising (on both the legal and business side) has taught me about avoiding lawsuits.

SOURCES OF LITIGATION IN FRANCHISING

Why is franchising any more troubled by litigation than any other form of doing business in America? I think it's due to **a number of factors**, including the fact that the **franchise method of distribution necessarily involves using**

“other peoples’ money” to grow the business, **the way some franchises are sold, the legalistic nature of the industry** and the **types of relationships some Franchisors develop with their Franchisees**. Let’s see what we mean by each of these.

At its most basic, franchising is simply a means of constructing a distribution network that, instead of relying on one company’s (the Franchisor’s) financial and human resources to grow through company-owned units (and usually accepting slower growth in a competitive marketplace), utilizes the financial and human resources of the Franchisees to put units “on the street” at a higher rate than could be done otherwise. In a very real sense, **Franchisees are investors in a common enterprise with the Franchisor** and in a healthy franchise system each entity is bringing something to the common enterprise that adds value for all participants.

If you adopt this attitude, and see Franchisees as a special type of investor, your attitude toward them can change. However, it’s just as important to understand that they are a very special type of “investor.” Unlike a passive investor in the stock market, their success depends critically on their abilities. Notwithstanding the way some franchises may be sold, passive management is almost never likely to generate success in franchising, either at the retail level or at the Franchisor’s plane. **The basic business realities remain**: No matter how good the franchise system is, **investment in any franchise involves business risks, the Franchisee’s volume, profit & success are primarily dependent on his/her ability and efforts as an independent business operator and success can’t be guaranteed**.

While buying a franchise may improve the Franchisee’s chances for success, any franchise is a speculative investment, significant additional funds beyond those outlined in any Offering Circular may be necessary to succeed, **there’s no guaranty of success and the most important factors in the success of any Franchise are the Franchisee’s personal business, marketing, management, judgment and other skills and, frankly, his/her willingness to work hard and follow the Franchisor’s system**.

To say all of this is not, I think, excessively negative but is simply a recognition of business realities (and, in fact, models language we recommend that our clients put in their offering circulars and franchise agreements for improved legal protection.) **If you accept these observations as business realities, why not say so to the prospective Franchisee and buy yourself some credibility and legal protection at the same time?**

Another factor comes into play here: **the Franchisee’s psychology**. It’s very difficult for most people to admit, even to themselves let alone to others, that they’re the ones ultimately responsible for their lack of success. **Very few people are able to say “Yes, I failed in this business and I really have no one to blame other than myself.”** Given that very human failing, when the Franchisee fails to achieve his or her goals, who’s left to blame other than the

Franchisor? Particularly, if the franchise has been sold on the basis that “we have such a great system, all you need to do is open the doors and the business will just come rolling in!”

In addition, **franchising is a highly legalistic industry and the legal structure is tilted, in many cases, in favor of the Franchisee.** God forbid that the Franchisor only disclosed the prospective Franchisee for 9 business days, ignoring the fact that the short disclosure in no way caused the Franchisee’s failure! Or pity the poor Franchisor who has documents that fail to keep it away from the functional equivalent of the O. J. Simpson jury.

While there’s little cure likely to appear on the horizon for the existing legal structure, that fact should make us all the more careful in designing the structure of our franchise sales systems and the provisions in our documents.

Finally, as I try to develop in some detail below, franchising ultimately involves an on-going relationship. If the Franchisor believes that he or she can manage that relationship in a “**top-down” management mode without participation (but not control) by the system’s Franchisees, they ignore the realities of franchising** and expose themselves to (at a minimum) disputes and reduced effectiveness of the Franchisees in the marketplace and (at the maximum) on-going expensive and distracting litigation that will serve as a highly effective negative franchise sales tool.

With this background, let’s explore some of the specific ways that Franchisors can avoid litigation, starting with business matters, since they’re the most important and productive.

BUSINESS TECHNIQUES FOR AVOIDING LAWSUITS

Realizing that I, as a lawyer, can’t have much impact in the area, I have to confess that **the single most important factor in causing much Franchisee litigation is simply that the Franchisee isn’t making money.** I’ve seen a number of systems where there may be significant tensions between the Franchisor and its Franchisees, where relationships may even have broken down, but if the Franchisees are generally successful, the exposure to litigation drops significantly. While a lawyer can’t do much to create this type of successful business environment, it’s probably helpful to note that most (but not all) Franchisor/Franchisee disputes are grounded in the fact that the Franchisee isn’t making as much money as he/she needs or wants.

The second most frequent cause of litigation probably is situations in which the Franchisor is at least perceived by the Franchisee as having **broken the trust relationship (if not having outright lied)** at some point in the relationship. Note that I’m focusing on perceptions here; it’s almost irrelevant whether or not the Franchisor actually did anything wrong - what’s important is that the Franchisee feels that he or she has been sold a bill of goods and, understandably, wants to get even. Under this heading come such things as **earnings claims, over-**

promising and under-delivery of services, encroachment, etc.

My experience has been that the Franchisor/Franchisee relationship begins to go downhill not through any conscious decision of the Franchisor but generally from a simple **failure to look at the relationship as it appears from the side of the Franchisee**. I'm not suggesting that the Franchisee's viewpoint is necessarily the "correct" one and Franchisees can be as narrow-minded, short sighted and unaware of business realities as anyone else. But since franchising necessarily involves a relationship between the Franchisor and the Franchisee, it only makes good business sense to focus on that relationship and what the other participant's perceptions of it are.

If the Franchisor does that, a valid approach is for the **Franchisor to regularly ask itself if it really is handling the relationship in the same way it would want the relationship handled if it was the Franchisee**. If, after some objective reflection, the Franchisor can say that its Franchisees would reasonably want greater inclusion, innovative services, more retail-oriented and realistic support, then the next few steps should be obvious. Perhaps this is nothing more than the simple application of the Golden Rule.

Aside from asking itself, **the Franchisor that wants to avoid litigation should consider regularly checking in with its Franchisees as to how they evaluate the performance of the Franchisor**. In any other business, the service provider would want regular input as to how its "customers" feel about he performance of the provider. It's difficult to understand why a Franchisor would have a different approach, unless it was afraid of the answers it might get. And that, in itself, should be a warning of an environment in which litigation is likely. In this regard, **use of Franchisee Advisory Councils is probably vital**. Few good franchise systems lack them.

Related to this is a question of attitude. **If the Franchisor sees the franchise relationship as "us vs. them," mutual success is pretty unlikely**. On the other hand, if the Franchisor is able to create a sense of team spirit and a joint endeavor in accomplishing mutually shared goals, it's a lot more likely that the franchise enterprise will prevail over the competition. In a very real sense, a successful franchise system is a lot like a mature and successful marriage - basic differences probably always exist on some level but they're accommodated through common goals and mutual respect. Top-down management simply doesn't work in either environment.

At the same time, litigation avoidance (even in the business sphere) isn't just a case of the Franchisor spreading sweetness and light throughout the system and rolling over whenever challenged by a Franchisee. Obviously, **any successful business has core values and ultimately stands for something**.

If the Franchisee is unable or unwilling to perform within the bounds of what we call "Franchising 101" - following the core requirements of the system and

paying his/her bills - then the Franchisee needs to leave the System.

Franchisors that fail to enforce basic system standards or allow financial deficiencies to go unresolved, ultimately do four things:

- Reduce the Value of Each Franchise
- Reduce the Value of the Franchisor
- Encourage Further Non-Compliance
- Maximize Litigation

In a very real sense, what the Franchisee is buying from the Franchisor is not just a trademark, expertise, shortened learning curve, or an increased chance of success. **What they're buying is leadership** and sophisticated, as well as novice, Franchisees want that. When the Franchisor fails to provide that strong and wise leadership, everyone involved is ultimately cheated.

Finally, the short answer to the question "What should a Franchisor do from a business standpoint to minimize litigation?" may just be this:

As you manage your franchise system, ask yourself what the best practices have been of the most successful (which are not necessarily the largest) franchise systems. Then adapt those practices to your system, changing them only when they don't work or where a clearly superior alternative exists. In short, why re-invent the wheel?

LEGAL TECHNIQUES FOR AVOIDING LAWSUITS

Legal tools supplement and support business ones. While the legal techniques are probably less important in the long run, they're generally easier to implement and provide a critical "safety net" for protection against litigation. Let's review a part of the wide range of these tools, generally under the headings of legal tools related to the franchise sales process and those relating to provisions in the franchise agreement.

1. Franchise Sales Process Tools

Earnings Claims

The Franchisor should be aware of the exposure involved in doing anything that can be construed as an "earnings claim," including such subtle ones as working with a prospective Franchisee in preparing a business plan or a loan application.

Statement of Prospective Franchisee

This document serves as independent verification that (1) all UFOC delivery requirements have been complied with and (2) no earnings claims, side-deals, other promises, etc. exist. It's proven highly useful, both in torpedoing potential litigation claims and as a management tool in verifying that required procedures have been complied with.

Pre-Acceptance Interview

Used to verify that no significant business misunderstandings exist before the sale is concluded (e.g. no financing contingencies, no misunderstandings regarding advertising or other support, etc.)

2. Technical Franchise Law Compliance

Registration

As obvious as this might seem, it can be more subtle than it seems and I've seen Franchisors expose themselves to liability through technical errors. This includes things like making sure which state's laws apply to a proposed transaction, complying with notice and required language requirements in non-registration states (Michigan, Nebraska, Florida, etc.), filing documents where required by negotiated sales or modifications to an existing franchise agreement with a Franchisee, etc.

Proper Disclosure and Evidence You Did It Right

Although most Franchisors understand the need for proper disclosure, errors can occur in complying with the ten-business day and five-business day rules, offering franchises or closing sales while a registration is lapsed, failure to update documents on a timely basis after a material development, etc.

In addition, Franchisors need to be aware that disclosure compliance substantially identical to what is done with new Franchisees will also be required when additional franchises are awarded to an existing Franchisee (for example, under an area development deal), renewals, transitions from a conversion status to a regular franchise, re-sales of an existing franchise, etc.

3. Franchise Agreement Provisions

Although business people understandably view many of the clauses in the franchise agreement as "boilerplate," these provisions can have the ability of completely avoiding litigation or substantially reducing a Franchisor's exposure. Let's review some of the major ones, all of which have been successfully included in Franchisor's documents and been registered in many states.

- Releases of all claims by the franchisee on assignment, renewal or issuance of additional franchises (e.g. 2nd franchise on area development deal) or on relocation.

- Development standards and the exit strategy — requires the franchisee to reach and maintain specified production levels (or system averages) or he/she will have territory reduced or will be required to leave the system.
- Repeated defaults result in termination, even if repeatedly cured.
- The “friendly divorce” provision — allows the Franchisor, at any time, to return the initial franchise fee, require the Franchisee to de-identify the unit, Franchisee continues in business and the Franchisor obtains a release.
- Mandatory mediation and (if mediation fails, as it rarely does) binding arbitration.
- Waiver of jury trial.
- Choice of venue — if a dispute has to be arbitrated, the arbitration should be at the Franchisor’s headquarters, not 1,500 miles away.
- Waiver of punitive damages.
- No class actions.
- Prior notice of claims and opportunity for Franchisor to cure before legal proceedings even begin.
- Shortened statute of limitations — Franchisee has 180 to 365 days to sue, suits barred after that time.
- No attorney’s fee recovery by either side — attorney’s fee clauses encourage litigation and generally benefit the attorneys!
- Non-retention of funds by franchisee in a dispute — the Franchisee is required to continue making regular payments of royalties, ad fund contributions, etc.
- Choice of laws — especially important in some jurisdictions to maximize enforcement of non-competes.

4. Operational and Other Matters

Site Selection Acknowledgement

For site-specific businesses, this document has the Franchisee confirm that the location selected has been chosen by him/her and is the Franchisee’s sole responsibility, not the Franchisor’s.

Paper Trails

One of the best tools you can have to avoid litigation is to have a solid paper trail in your files. This can demonstrate such things as the Franchisee's satisfaction level with initial training, his/her non-attendance at on-going training, customer complaints, operational non-compliance, audits turning up financial and other violations, your efforts to help him/her resolve problems, etc.

5. Post-Litigation Evaluation

Even the best franchise systems may occasionally have litigation with their Franchisees. What mature systems do is to handle litigation like any other business problem, including an objective evaluation of how the problem came up and reached this stage, as well as revising procedures where necessary to make sure it doesn't happen again. What's important from a management standpoint is to not just fall into a defensive, "circle the wagons" mentality, but to evaluate the problem like any other business challenge.

6. Winning Lawsuits

Over 20 years' experience indicates that among the other techniques for keeping litigation expenses down, an important one is often overlooked - winning. Few things send a better message to those contemplating litigation than watching another Franchisee fail to prevail. Picking the right litigation counsel, supporting and closely managing them and giving them the right tools in your documents and "paper trails" will go a long way to this end.

Mr. Holmes is the Managing Partner of Holmes & Lofstrom, LLP, a U. S. -based law firm which is a member of the International Franchise Association, and specializes in international franchising transactions, including bringing Australian-based concepts to North America. He has been involved in the legal and business aspects of franchising for nearly 30 years and can be reached at D.Holmes@HolmesLofstrom.com or in the firm's Northern California office at 805-547-0697. Firm references and biographies are available on request.