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ADVERTISING AND MARKETING FUNDS: WHAT ARE YOU DOING WITH "MY" MONEY?

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TABLE OF CONTENTS

ADVERTISING AND MARKETING FUNDS: WHAT ARE YOU DOING WITH "MY" MONEY?

I. INTRODUCTION

The funds that are collected and spent on marketing are an important and often contentious subject in any franchise system. Entrepreneurs become franchisees in large part based on the guidance and support promised by the franchisor and the ability to pool resources with others to build a better and more recognizable brand. One of the most valuable ways that resources can be aggregated and applied is through marketing, usually in the form of a fund to which everyone contributes.

Unlike royalty and other system fees that franchisees pay to the franchisor to support bland back office support and operations, the end product of money spent on marketing—often in the form of buzzy advertising—appears in various public platforms to promote the franchise's brand to potential and existing customers. Franchisees can actually see their contributions being spent on social media, television, radio, mail, and other media and accordingly form opinions on whether they like what they see. Franchisees are also likely the first to hear directly from customers about the effectiveness of marketing strategies. As such, franchisees often consider the marketing fund as a pot of their money, earmarked to be used to their benefit.

Yet franchisors often see marketing funds as their money to use broadly and discretionarily on brand development and promotion. After all, franchisors developed and control the brand and hold the trademarks. Provisions relating to marketing funds in franchise agreements are often very broad—and have become broader over time—giving franchisors the ability to use the funds in a multitude of ways. Franchisees do not always agree that the chosen usage best suits the system generally or them individually.

The positions taken by franchisors and franchisees in relation to the marketing funds are not necessarily exclusive of each other. Yet franchisors and franchisees alike can take unreasonable positions, and throughout this paper the authors urge them to take a measured approach. For example, franchisors should seek buy-in from franchisees when they intend to use marketing funds to make large investments in campaigns or go in entirely new directions. Both sides have a vested interest in seeing the marketing fund spent in the best way possible. Indeed, when asked to resolve a dispute related to marketing in the KFC system, the Delaware Chancery Court provided all franchisors and franchisees with delicious wisdom to savor:

> The franchisees have a strong incentive to be good shepherds of the KFC brand. If the KFC brand is impaired, KFC franchisees stand to suffer as much as [the franchisor]. The franchisees would be foolish to ignore thoughtful plans proposed by [the franchisor], as foolish as [the franchisor] would be to ignore the views of those who sell directly to KFC customers.[1]

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[1] KFC Nat'l Council & Advert. Coop., Inc. v. KFC Corp., No. 5191-VCS, Bus. Franchise Guide (CCH) ¶ 14,542 (Del. Ch. Ct. Jan. 31, 2011).

When franchisors and franchisees cannot agree, they risk becoming embroiled in protracted and expensive litigation, as was the case in the Meineke system. In 1993, Meineke franchisees brought a class action alleging that the franchisor formed and operated an in-house agency to utilize the marketing fund for its own benefit by, *inter alia*, charging inflated or fabricated advertising fees, accepting "kick-backs" from advertisers, and purchasing advertising that did not benefit franchisees.[2] The franchisor eventually prevailed and reversed a $390 million verdict against it, but not without experiencing the unpredictable ups and downs and uncertainty that litigation often involves. Indeed, high-profile disputes over marketing continue to this day: as recently as February 2020, Tim Hortons U.S. franchisees brought suit against their franchisor and its corporate affiliates in federal district court for charging operational and administrative expenses to the advertising fund that allegedly bore no relation to advertising.[3]

Sections II and III of this paper explore commonly encountered issues with marketing funds, such as disclosure requirements and contract drafting considerations. Sections IV, V, and VI discuss complex and specialized issues that arise as systems grow and develop over time. Section VII addresses procedural issues in dispute resolution. The authors have endeavored to give a balanced view with franchisor and franchisee counter-points where those are likely to exist. For the sake of brevity, marketing is used in this paper as an umbrella term to include advertising, branding, promoting, and other related activities in which marketing funds often engage.

II. DISCLOSURE REQUIREMENTS: YOU DID NOT TELL ME THAT BEFORE I JOINED THIS SYSTEM

A. Disclosures Required by Federal Regulation

The FTC Franchise Rule[4] is a consumer protection law. At its heart is an effort by the federal government to ensure that prospective franchisees know as much as possible about the investment they will be making, without making the disclosure obligations imposed overly burdensome for franchisors.

Because of its importance to franchise systems, relatively extensive franchise disclosure document ("FDD") disclosures are required about marketing funds. Although much less common, some state laws also require pre-sale disclosures about marketing funds. Those are discussed below in Section II.B.

In the FDD, most of the marketing fund disclosures can be found in Item 11.[5] Pursuant to Section 436.5(k)(4) of the FTC Franchise Rule, franchisors must disclose information about how

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[2] Broussard v. Meineke Muffler Shops, Inc., 155 F.3d 331 (4th Cir. 1998).

[3] Complaint for Declaratory Relief, Great White North Franchisee Assoc.-USA, Inc. v. Tim Hortons USA, Inc., No. 1:20-cv-20878-BB (S.D. Fla. Feb. 27, 2020).

[4] Disclosure Requirements & Prohibitions Concerning Franchising, 16 C.F.R. § 436 (2007) (the "FTC Franchise Rule").

[5] Other sections of the FDD also include some information about the marketing fund. For example, Item 6 includes information about marketing fund fees, and if any fees are due before a franchisee opens its business that information must be included in Item 5 of the FDD. Litigation involving the marketing fund may have to be disclosed in Item 3. An in-depth, itemized review of marketing fund-related FDD disclosures is included in Erika L. Amarante & Eric H. Karp,

the marketing fund is managed, who contributes to it and how much, how the franchisor uses the fund, and what insight franchisees have into the fund usage.

An inherent problem in the FDD structure—for franchisors and prospective franchisees alike—is that the document may only include the information mandated by the FTC Franchise Rule.[6] When registering their FDD with franchise registration states, franchisors that try to include additional information will often be required to remove it by state franchise examiners. Without a registration, the franchisor cannot offer and sell franchises in the examiner's state, so the information usually ends up being taken out to comply with the examiner's request. Yet there is no prohibition on franchisors sharing additional information with prospective franchisees outside of the FDD,[7] which often does not happen, at least as far as marketing funds and strategies are concerned. The franchisor may not know where the prospective franchisee's interest lies, and the prospective franchisee may not know what information to request.

1. Advertising Councils and Cooperatives

Although disclosure requirements regarding advertising councils are in a separate section from those relating to marketing funds, the two topics usually go hand-in-hand. A franchisor that has not set up a marketing fund typically also has not set up an advertising council. Both disclosures are important to prospective franchisees. The information about advertising councils gives prospects information about the level of input and insight they and other franchisees may have over marketing decisions of the franchised brand. The marketing fund section, apart from informing prospects about a mandatory expense, is also relevant for prospects to understand what pooled resources are being put in to promoting the franchised brand.

The FTC Franchise Rule requires franchisors to disclose how members of the council are selected, whether the council is advisory, or whether it has operational and decision-making authority, and whether the franchisor has the power to form, change, and dissolve the council.[8] Almost uniformly, advertising councils only have advisory powers. There are few examples of councils with decision-making power, but they can sometimes be found in older systems, or in systems where a dispute between the franchisor and franchisees at large brought about a systemic power shift with respect to marketing. The KFC system, mentioned in the introduction and discussed below in Section IV.A is one example of a franchisee-controlled council (although technically, it is a franchisee-controlled advertising co-op). Franchisors use advertising councils as a sounding board for marketing ideas they are developing and to solicit buy-in from franchisees.

The FTC Franchise Rule also requires extensive disclosures about advertising cooperatives. Disclosures relating to advertising cooperatives are covered in Section 436.5(k)(iv) of the FTC Franchise Rule and require a franchisor to disclose if franchisees are required to participate in local or regional advertising cooperatives. The franchisor must disclose how the area or membership of the cooperative are defined, the franchisee's required contribution,

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Best Practices in the Use of System Advertising & Marketing Funds, ABA 34TH ANNUAL FORUM ON FRANCHISING W-6 (2011).

[6] 16 C.F.R. § 436.6(d) (2007).

[7] With the exception of the restrictions on financial performance representations.

[8] 16 C.F.R. 436.5(k)(4)(iii) (2007).

whether other franchisees are contributing at a different rate, whether franchisor-owned outlets must contribute and at what rate, who administers the cooperative, whether there are written governing documents for the cooperative and whether they are available for franchisee review, whether the cooperative must prepare annual or periodic financial statements and whether they are available for franchisee review, and, finally, whether the franchisor has the power to form, change, dissolve, and merge the cooperative.

While the required disclosures about cooperatives are similar to those about marketing funds and advisory councils, they are not the same. Some differences are not surprising. For example, there is no requirement to disclose whether the franchisor can merge different advertising funds. Most franchisors only have one marketing fund, so a question about merging advertising funds would be superfluous in most cases. However, other differences are more surprising. For example, a franchisor has to disclose if there are governing documents for the cooperative available for franchisee review, but does not have to make any similar disclosure about advertising councils.

2. <u>Marketing Fund Contributions</u>

If the first question a prospective franchisee asks is "How much money will I make?", the second may well be "How much will it cost to make that money?" A franchisor with a marketing fund has to disclose information about who will contribute to the marketing fund, how much the franchisee will have to contribute, if other franchisees contribute at a different rate, and whether the franchisor-owned locations also contribute to the fund.

The disclosures required by the FTC Franchise Rule are often forward-looking, focused on disclosing to a prospective franchisee the exact terms it will obtain from the franchisor, not disclosing terms granted existing franchisees. But the marketing fund disclosures are a rare exception. While the franchisor does not have to be specific about what different deals it has struck with existing franchisees, it must nonetheless share with its prospective franchisees if others are not contributing to the marketing fund at the same rate. It is not uncommon for start-up franchisors to negotiate with their first several franchisees, and marketing fees are usually part of the negotiations. While a franchisor may not have to disclose whether other fees under the franchise agreement are the same for all franchisees, a negotiated marketing fee will have to be disclosed.[9] Likewise, franchisors choosing not to contribute to the marketing fund for their own locations will have to disclose that information.

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[9] Item 6 of the FDD requires franchisors to disclose whether fees are uniformly imposed, and franchisors therefore arguably have to disclose whether other fees have been negotiated. It is not clear whether the Item 6 disclosure is forward- or backward-looking. Most franchisors treat it as forward-looking and only disclose if fees will not be applied the same to the prospective franchisees receiving the FDD. It is also common for franchisors to disclose in Item 5 whether they negotiated the initial franchise fee in the previous year. While franchisors that do not have a fixed initial franchise fee are required to disclose the formula or range used in the previous fiscal year to calculate the initial fee, it is still common for franchisors with a fixed initial franchise fee to disclose if the initial franchise fee was negotiated. Finally, note that the California franchise law ("CFIL") may require disclosure of negotiated terms to prospective franchisees subject to the CFIL. Under the CFIL, franchisors have to provide prospective franchisees with a separate disclosure regarding material negotiated terms between the franchisor and a California franchisee during the 12-month period before the disclosure. The disclosure statement must include information about how to obtain a copy of the negotiated terms. This provision is an exemption from registration of the revised offer and is only available if the negotiated terms, on the whole, are beneficial to the franchisee. CAL. CORP. CODE § 31109.1.

That disclosures about marketing fund contributions are both forward- and backward-looking is not surprising. For example, it is of little importance to a prospective franchisee to know that existing franchisees were offered a different length of term, different conditions for renewal, or that their termination provisions are different. Though it may feel unfair, those types of different terms do not have any direct impact on the prospective franchisee's future business. However, if different brand locations contribute at different levels to the marketing fund, that will have a more direct impact on the prospect's business. If the franchisor is currently requiring franchisees to contribute to the marketing fund at 3% of gross revenue, but previously required only a 1% contribution (or none at all), failure to disclose the discrepancy in contribution levels would give a prospective franchisee an incomplete picture of the funds that will be available through the fund.

3. How Marketing Funds Are Used

Item 11 of the FDD does not provide much in-depth information about how a system's marketing fund is used. Franchisors need not provide much detail about the permitted usage of the marketing fund pursuant to the franchise agreement, yet many choose to disclose this information. Examples of common marketing provisions are discussed below in Section III.C. Franchisors must give a brief overview of how the marketing funds were used in the previous year by reporting the percentage of amounts spent on four different categories: production, media placement, administrative expenses, and "other use."[10] For the "other use" category, franchisors have to provide a brief description of what was included. Franchisors must also disclose whether any of the marketing fund is used to solicit new franchise sales, which also must be reported as a percentage of the total marketing fund spend.

Finally, franchisors must disclose what happens if not all funds collected are used in the fiscal year in which they accrue and what the franchisor will do with the unused amounts. It is common for franchise agreements to state that amounts not used during the fiscal year in which they were collected will be carried forward to the next year.

While it is easy to imagine that a franchisor with a successful marketing strategy and fund would like to share that information with prospective franchisees, the FDD is not the place for such information. The FTC Franchise Rule limits the franchisor's ability to share additional information in the FDD than what is required by the Rule. Strictly speaking, even disclosures about the permitted scope of marketing fund use are outside the scope of required disclosures, but state franchise examiners will usually not comment on the inclusion of such information.

4. Franchisees' Insight into Fund Usage

Item 11 must also include information about who administers the fund, whether and when the fund is audited, and if the financial statements of the fund are available for review by the franchisee. Information about the marketing fund and the advertising council often blend together in Item 11. Although franchisors commonly administer the marketing fund, many want to highlight the role of their advertising council here to let prospective franchisees know that they will play some role in how amounts are spent.

There are two different disclosures about financial statements that should be disclosed in Item 11: first, whether the general marketing fund financial statements are available for franchisee

[10] 16 C.F.R. § 436.5(k)(4)(v)(G) (2007).

review; and, second, what happens to marketing funds not spent in the year they were collected. The franchisor must disclose whether franchisees will receive periodic accountings of how those funds were spent.

B. **<u>State Laws Impacting Marketing Funds</u>**

It is relatively unusual for state franchise laws to specifically address marketing funds, but there are a few that do, directly or indirectly.[11]

Arkansas is the only state with laws or regulations that have direct impact on advertising-related contract terms that are common in franchise agreements. The Arkansas Franchise Practices Act prohibits a franchisor from collecting a percentage advertising fee and not using the funds to advertise the business the franchisee conducts.[12] However, the definition of a "franchise" under the act is different from the three-part tests seen in most other states with franchise laws.[13] Also, the statute explicitly excludes from its scope franchises subject to the FTC Franchise Rule.[14] As a result, this statute is of little importance to most franchisors and franchisees.

Several other states have regulations that prohibit discrimination or broadly require good faith and fair dealing.

Indiana makes it an unlawful to require franchisee participation in advertising or promotional campaigns or contests if the related expense is indeterminate, determined by a third party, or determined by a formula. However, the practice is permitted if the franchise agreement specifies a maximum percentage of gross monthly sales or a maximum amount.[15] Since most franchise agreements specify the advertising fee either as a percentage of gross sales or a fixed monthly fee, the Indiana provision will rarely apply. As several other state laws discussed below, Indiana also makes it unlawful for a franchisor to discriminate unfairly among its franchisees.[16]

Hawaii requires franchisors and franchisees to deal with each other in good faith, and also prohibits franchisors from discriminating between franchisees with regard to advertising services.[17] It is not considered discrimination, however, if the different treatment of franchisees

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[11] Lauren Smith Madden argues that state laws such as "Little FTC Acts" and common law theories such as the implied covenant of good faith and fair dealing indirectly regulate advertising funds. Lauren Smith Madden, *Not Your Mama's Advertising Fund: Best Practices in the Use of Franchise System Advertising Funds*, 38 FRANCHISE L. J. 379, 384 (2019). Since such statements are generally true about any part of a franchise agreement (and most other agreements), this paper does not explore those types of statutes and theories.

[12] ARK. CODE ANN. § 4-72-206(7).

[13] "Franchise" defined as: "a written or oral agreement for a definite or indefinite period, in which a person grants to another person a license to use a trade name, trademark, service mark, or related characteristic within an exclusive or nonexclusive territory or to sell or distribute goods or services within an exclusive or nonexclusive territory at wholesale or retail, by lease agreement, or otherwise." ARK. CODE ANN. § 4-72-202(1).

[14] ARK. CODE ANN. § 4-72-203. *See also* J.K.P. Foods, Inc. v. McDonald's Corp., 420 F. Supp. 2d 966 (E.D. Ark. 2006).

[15] IND. CODE § 23-2-2.7-1(11).

[16] IND. CODE § 23-2-2.7-2(5).

[17] HAW. REV. STAT. § 482E-6(1), (2)(C).

is due to (1) franchises being granted at different times, (2) a program making franchises available to persons with insufficient capital, business experience, or lacking other qualifications, (3) regional program experimentation or variations in product or service lines, (4) a franchisee curing a default, or (5) other "reasonable distinctions" that are not arbitrary.[18] Finally, Hawaii also makes it unlawful for a franchisor to require a franchisee to purchase goods and services from designated sources unless the restrictive purchasing agreement is reasonably necessary for a lawful purpose that can be justified on business grounds.[19]

Washington also prohibits discrimination between franchisees with respect to advertising services, and, like Hawaii, does not consider it discrimination as long as the different treatment is reasonable, not arbitrary, and either relates to franchises granted at different times, or is otherwise proper and justifiable.[20]

Illinois likewise prohibits discrimination with respect to advertising services, but only if the discrimination would cause competitive harm to a franchise vis-à-vis the franchisee who received the beneficial treatment. Like Hawaii and Washington, it is not discrimination if the treatment is due to the franchise agreements being entered into at different times, is related to a program for people of limited means or that lack other qualifications, is related to local variations, or variation of product or service lines, is related to the cure of a default, or is based on other reasonable distinctions, and is not arbitrary.[21]

Minnesota, through its franchise regulations, makes is an unlawful practice to discriminate between franchisees with respect to advertising services, unless these different terms are due to franchised granted at different times, different geographies, markets, volumes or size, franchisor costs, or other reasonable grounds.[22]

Iowa also imposes an obligation of good faith on both parties, but the statute does not elaborate on what this means beyond explaining that good faith means "honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade."[23]

While there are many cases in which franchisees have relied on the statutes to allege discriminatory treatment or a breach of the duty of good faith, the authors have not been able to find any case law applying these statutes to marketing funds. Yet franchisees seeking to right any perceived marketing-related wrong by relying on these statutes will likely face an uphill battle. Courts analyzing the discrimination statutes usually find that other franchisees to which the plaintiff franchisee compares itself are not similar to the plaintiff, or that, even if there was

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[18] HAW. REV. STAT. § 482E-6(2)(C).

[19] HAW. REV. STAT. § 482E-6(2)(B).

[20] WASH. REV. CODE § 19.100.180(2)(c).

[21] 815 ILL. COMP. STAT. 705/18.

[22] MINN. R. 2860.4400(B).

[23] IOWA CODE § 523H.10; IOWA CODE § 537A.10.11.

disparate treatment, it does not amount to unfair discrimination. The standard for good faith and fair dealing claims is generally very hard to overcome, and these statutes do not lower that hurdle.

Andy Mohr Truck v. Volvo Trucks is an instructive case in which a Volvo Truck franchisee claimed that the franchisor's lack of a price comparison process and failure to attempt to compare price concessions amounted to discrimination under the Indiana Deceptive Franchise Practices Act ("IDFPA").[24] The Seventh Circuit addressed two key issues under IDFPA: when are franchisees similarly situated, and what must the plaintiff show in order to prove unfair competition.

With respect to the first question, the court looked to whether the franchise/dealer agreements the franchisees operated under were the same, whether the same sales and marketing policies applied to the different franchisees, and whether the franchisees had purchased the same truck models from the franchisor. Finding that this was the case, the court moved on to analyze when disparate treatment can be considered unfair discrimination. The franchisee had introduced evidence of thirteen transactions in which it had received less favorable pricing terms than other franchisees. Although Volvo claimed that the transactions were cherry-picked and that the franchisee had actually received the same or better pricing in 79% of the relevant transactions, the court instead focused on the franchise agreement provision that allowed price discrepancies between different franchisees. The Seventh Circuit accordingly found that there was no claim for unfair discrimination and provided useful guidance:

> This is not to say that a franchisee operating under similar terms could never make a showing of discrimination under the statute. For instance, a franchisee might be able to show that it was consistently awarded worse concessions than its comparators. A franchisee could also show that a franchisor violated its agreement, offered it worse agreement terms than other franchisees, or discriminated against it by offering less favorable terms for the same purchase by the same customer.[25]

The reference to franchisees showing a violation of contract terms may or may not be helpful to franchisees trying to assert discrimination claims. The close tie between these types of discrimination claims and breach of contract claims can muddy the waters. Other courts have dismissed statutory discrimination claims and focused solely on the underlying contractual issues.[26]

III. PROVISIONS ON COLLECTION AND USAGE: YOU WANT HOW MUCH EVERY WEEK?

Typical franchise agreements will contain provisions relating to an existing or potential future marketing fund. With franchise agreement terms lasting up to a decade or more,

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[24] Andy Mohr Truck Ctr., Inc. v. Volvo Trucks N. Am., 869 F.3d 598, 605 (7th Cir. 2017).

[25] *Id.* at 607

[26] For example, in *Gre-Ter Enters., Inc. v. Management Recruiters Int'l, Inc.*, 329 F. Supp. 3d 667 (S.D. Ind. 2018), a franchisee claimed that the franchisor had advertised the franchisee's exclusive territory to other franchisees and granted other franchisees rights in that territory. The court dismissed the discrimination claims under Indiana law as unfounded.

franchisors are well-advised to build in as much flexibility as possible in the franchise agreement, including the provisions relating to the marketing fund.

It is problematic when a franchise system's early franchise agreements, entered before a marketing fund was created, do not include a marketing fund provision. While a franchise agreement creates a contractual bond between the franchisor and the franchisee, the marketing fund, once created, creates a bond among all of the franchisees in the system. The marketing fund is intended to be used for the common good of the entire franchise system, and there is fairness in having all locations contributing to the fund. If some franchisees are not required to contribute, they are or may be perceived as free-riders. Of course, the result of having free-riders is less total funds available to spend on marketing. Rectifying this problem once the system is more established typically would require renegotiating the form of the franchise agreements that lack a marketing fund provision.

While most modern franchise agreements contain a marketing fund provision, the provisions are far from uniform across systems. The scope of for what the funds can be used, how they are administered, and what rights the franchisor reserves to change the fund management are but a few issues that may differ in agreements. What follows is a review of some of the key aspects of marketing fund provisions, how they may differ, and some of the possible consequences that may follow certain drafting choices. By no means is this an exhaustive review of possible marketing fund provisions.

A. <u>Collection</u>

The provision regarding collection of the marketing fund fee is rather straight-forward, but there is plenty of room for nuance. It will typically state that the fee is payable with a stated frequency on a specific date. The provision may also provide how the fee is to be collected, for example, by electronic fund transfer ("EFT"). Although the issue of consistency of marketing fund obligations discussed further in Section V is of lesser relative importance with respect to collection than with respect to other marketing fund related issues, franchisors may still wish to build in some flexibility into the collection provision. The following is an example of a general collection provision that would apply to the marketing fund fee, and other fees payable under the franchise agreement:

> Unless payments terms to the contrary are expressly stated in this Agreement, or otherwise, all payments required by this Article, and all other payments due to Franchisor on a continuing basis ("Payments"), shall be due to Franchisor by the fifteenth (15th) day after the end of the calendar month in which such Gross Room Revenue were received by Franchisee, provided that, Franchisor may, upon notice to Franchisee, collect such payments more frequently than monthly. If any Payment due to Franchisor under this Agreement is overdue, Franchisee shall pay to Franchisor immediately upon demand the overdue amount, together with a late charge on such amount from the date it was due until paid, at the rate of 1.5% per month, or the maximum rate permitted by law, whichever is less. All Payments shall be made by wire transfer or electronic funds transfer or such other electronic transfer method as Franchisor may designate. Franchisor may collect Payments required by this Article by direct debit withdrawal by Franchisor from a designated bank account of Franchisee.

The above provision gives the franchisor the ability to make collection-related changes as the system and available technology changes. For example, while the fee collection is currently on a monthly basis, collection can occur on a more frequent basis in the future. Likewise, the provision allows technological and methodological flexibility. Being able to use the same technology for fee collection from all franchisees may not be possible unless the agreement provides some room for change over time.

Most marketing funds are simply a separate account with the franchisor entity (a separate bank account, or a separate line item in the franchisor's books); however, in some instances, the franchisor sets up a separate legal entity to administer and manage the marketing fund. In those instances, the franchisor forwards the collected funds to the marketing fund entity. Some systems that use a separate entity to administer their marketing funds may leave the collection of the marketing fund fee intentionally vague in order to provide for flexibility in this regard. Although the authors have no knowledge about the motivation behind the particular language in the Domino's Pizza franchise agreement, the result appears to be flexibility in collection for the brand advertising fund:

> All costs of the formulation, development and production of any such advertising and promotion (including without limitation the proportionate compensation of our employees who devote time and render services in the formulation, development and production of such advertising and promotion programs or the administration of the funds), will be paid from a separate fund administered by a separate not for profit entity (the "Advertising Fund"). You will be obligated to pay four percent (4%) of the weekly royalty sales of the Store to the Advertising Fund. Your contribution to the Advertising Fund must be paid by Thursday of each week on royalty sales for the week ending on the preceding Sunday. Payment must be made by electronic funds transfer as provided in Section 6.4 of this Agreement or as we may otherwise designate from time to time.[27]

There is no separate agreement attached to the FDD for the marketing fund entity or the franchisee to execute. Whether such an agreement would be required or advisable likely depends on many different factors. KFC, for example, includes a separate agreement because marketing monies are controlled by a cooperative in the KFC system. The cooperative and the franchisees enter into a separate "Advertising Agreement" that obligates the franchisees to pay a marketing fee.[28]

Franchisees' failure to pay their fees under the franchise agreement creates additional accounting problems. If a franchisee fails to pay both royalties and marketing fund fees, and the franchisor is only able to recover part of the past due fees, how should the recovered fees be applied? What happens to the interest the franchisor collects on the past due fees? And if the franchisor incurs legal or other expenses for collecting both royalty and marketing fund fees, how should those expenses be applied?

These types of issues were raised in *Moghaddam v. Dunkin' Donuts*, in which a group of Dunkin' Donuts franchisees raised allegations, *inter alia*, that the collection expenses the

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[27] Domino's Pizza Franchising, LLC, FDD, Section 13.1 of Standard Franchise Agreement, (Apr. 1, 2020) available at Wis. Dept. of Fin. Insts., https://www.wdfi.org/apps/FranchiseSearch/MainSearch.aspx.

[28] KFC US, LLC, FDD, (Mar. 20, 2020), available at Wis. Dept. of Fin. Insts., https://www.wdfi.org/apps/FranchiseSearch/MainSearch.aspx.

franchisor incurred in collection of royalties and marketing fund fees on underreported gross sales should be borne by the franchisor alone, even though the collection expenses were in part relating to marketing fund fees.[29] The franchisor countered that, even though it had not done so, the franchise agreement gave it the right to allocate the total collection expenses to the marketing fund. The court found both positions to be unreasonable and held that the franchisor could allocate the collection expenses fairly between the royalties and marketing fund fees collected.[30] As a result of cases like *Moghaddam*, franchisors may wish to add the following language to their marketing fund provisions:

> Any delinquent payments of advertising fees and royalties received will be allocated between the Fund and Franchisor according to the respective percentages of advertising fees and royalties owed. Any costs incurred in collecting such delinquent payments (including, without limitation, reasonable attorneys' fees) will be allocated between the Fund and the Franchisor in proportion to the respective percentages of advertising fees and royalties owed, but in no event may the collection costs allocated to the Fund exceed the delinquent advertising fees contributed to the Fund.[31]

B. Adjustment of Marketing Fund Fee

Different franchise agreements will set the amount of the marketing fund fee in different ways, but the most common approaches are to set it as a percentage of gross sales or as a fixed-dollar amount. Regardless of the option chosen, it is advisable to build in some flexibility to allow for the potential need to change the fee during the term of the franchise agreement. If the fee is a fixed-dollar amount, it may have to be adjusted for inflation during the term of the agreement, especially if the term is relatively long. Whether the fee is set as a percentage or as a fixed-dollar amount, the franchisor may also wish to be able to change it if it decides to expand the scope of fund activities. This may be less of an issue for mature systems, but for new franchisors it may be important. New franchisors will often start by only charging a small percentage towards the marketing fund, reflecting the relatively limited support the new marketing fund can provide the franchisees. As the system grows it may be better able to provide support and may want to provide more marketing support. In that situation, it may wish to increase the fee—something that will be hard to do without flexibility in the franchise agreement. But even for mature franchise systems, it may make sense to include this type of flexibility. When a franchise system is sold, prospective buyers may wish to be able to spend more on marketing, and not being able to raise the marketing fund fee may dissuade potential buyers. A potential provision may read:

> Franchisee will, for the entire term of Agreement, pay to Franchisor nonrefundable monthly Marketing Fees in an amount equal to up to 2.5% of Franchisee's monthly Gross Revenues. As of the Effective Date the Marketing Fee is 1% of Franchisee's Gross Revenues. At Franchisor's discretion, the Marketing Fee may be reduced or increased upon not less than thirty (30) days' notice to Franchisee. Independent of the Marketing Fund, Franchisor may, at its option, charge Franchisee a

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[29] Moghaddam v. Dunkin' Donuts, Inc., 322 F. Supp. 2d 44 (D. Mass. 2004).

[30] *Id.* at 48.

[31] Excerpt from the sample marketing fund provision in THE ANNOTATED FRANCHISE AGREEMENT (Nina Greene, Dawn Newton & Kerry Olson eds., 2018).

> reasonable fee on a project basis for marketing and advertising materials and projects prepared or undertaken for use by the Business System.

This provision allows for both an increase and reduction of the marketing fund fee. Permanent reductions are relatively rare, but some systems that experience a lot of seasonality may temporarily reduce the marketing fund fee during the slow season. It also allows the franchisor to charge an additional marketing fund fee on a project basis, which may be a good alternative for franchisors that are only introducing the marketing fund and only want to charge a low fee on a monthly basis. The provision calls for 30 days' notice of a change to the fee. Not all provisions permitting a change in fee will include a notice requirement.

A franchisor that wishes to change the amount of marketing fund contributions is well-advised to carefully consider what its reasons are for the increase, how the change is likely to impact the franchisees financially, and how it introduces the change to its franchisees. Unless other fees are reduced in equal amount to the increase of the marketing fund fee (for example, a required local fund spend is reduced in correlation to the increase), the increase will mean that the monthly payments from the franchisee to the franchisor will increase. The franchisor may wish to explain to franchisees how it plans to spend the additional fees and provide as much information as possible about how that additional spending is expected to translate into increased revenue (or cost reductions) for the franchisees. Even well-planned fee changes may result in disputes. For example, Baskin Robbins historically did not charge typical franchise fees and made its money on franchisee ice cream purchases. In 1998, the franchisor introduced a more typical fee structure with a royalty, marketing fund fee, and a mark-up on ice cream purchased from third parties called a "commercial factor fee."[32] Although the dispute primarily involved the franchisor's right to charge the commercial factor fee, it is a good example of how changes in fees often lead to conflict between franchisor and franchisees.

Start-up franchisors may not initially have a marketing fund, but they should include a provision in their franchise agreements that will allow them to create a fund in the future. Without such a provision, a franchisor may be forced to convince its franchisees that the idea of taking money out of their pocket to contribute to the communal marketing fund pot is a good idea when it is negotiating agreement amendments with each franchisee. The necessary language is not complicated:

> We have not yet established a Marketing Fund; however, we reserve the right to do so at any time. When we establish a Marketing Fund, you will pay us a weekly continuing Marketing Fund Fee of …

Typically the marketing fund provisions in start-up franchise system agreements will read similar to those in franchise systems with existing funds, but with the addition above.

C. <u>Permitted Usage</u>

Somewhat surprisingly, the biggest variety the authors found among marketing provisions was in the scope of marketing fund usage. A franchisor's dream provision would start by stating that the franchisor will use the marketing fund as it determines, in its sole judgment, for purposes including but not limited a long list of examples. It would specifically state that the fund can be

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[32] Ass'n of Indep. BR Franchise Owners v. Baskin Robbins Franchising, LLC, No. CV 16-10963-WGY, 2017 WL 4314607, at *1 (D. Mass. Sept. 27, 2017).

used to cover internal administrative expenses of the franchisor. Yet, there is significant variety. For example, the Domino's Pizza provision is relatively short:

> We or our designee will from time to time formulate, develop, produce and conduct advertising and promotional programs in the form and media as we or our designee determines to be most effective. … All costs of the formulation, development and production of any such advertising and promotion (including without limitation the proportionate compensation of our employees who devote time and render services in the formulation, development and production of such advertising and promotion programs or the administration of the funds), will be paid from a separate fund administered by a separate not for profit entity (the "Advertising Fund").[33]

It only refers to advertising and promotional programs, though it does cover internal, administrative expenses incurred by Domino's Pizza. In contrast, the marketing fund provision for WoodSpring Hotels, a Choice Hotel brand, provides:

> The Marketing Fund will be used to meet any and all costs of researching, developing and preparing national, regional, point of sale, and local direct sales advertising and marketing strategy materials for use by Choice Brand Hotels, including, without limitation, costs associated with developing, preparing, directing, administering, maintaining, and disseminating advertising, marketing, promotional, and public relations materials; conducting marketing research; maintaining a national sales and marketing staff and related expenses; development, maintenance and updates to the Choice Websites; joint promotional programs for all Choice Brand Hotels; and preparing, producing, broadcasting, and disseminating advertising and promotions, including, without limitation, radio, television, newspaper, magazine and Internet advertising, market surveys, public relations activities, and employment of advertising agencies. … All payments, plus income earned therefrom, shall be used exclusively for the above-stated purposes, and shall not be used to defray any of Franchisor's general operating expenses, except for reasonable salaries, administrative costs, travel expenses, overhead, and similar expenses Franchisor may incur in activities related to the administration of the Marketing Fund and all costs of development and preparing national, regional, point of sale, and local advertising materials for use within the System and/or Affiliate Systems.[34]

The mere length of this provision tells the reader that there must be more detail in this provision than in the Domino's Pizza example. It covers not only advertising and promotional programs, but a slew of related areas, such as marketing, public relations, marketing research, national sales programs, websites, as well as joint advertising programs with other Choice Hotel

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[33] Domino's Pizza Franchising LLC, FDD, Section 13.1 of Standard Franchise Agreement, (Apr. 1, 2020) available at Wis. Dept. of Fin. Insts., https://www.wdfi.org/apps/FranchiseSearch/MainSearch.aspx.

[34] Choice Hotels Int'l, Inc., FDD, Section 9.3 of the Franchise Agreement WoodSpring Suites (Apr. 15, 2020) available at Wis. Dept. of Fin. Insts., https://www.wdfi.org/apps/FranchiseSearch/MainSearch.aspx.

brands. It also covers administrative expenses in somewhat greater detail than the Domino's Pizza provision, although it is still relatively vague in that regard.

A franchisor's expenditure of marketing fund dollars on internal administrative expenses are frequently contentious, and can lead to litigation. Franchisors are therefore well-advised to be as clear as possible when describing what type of administrative expenses the marketing fund can cover. An interesting example can be found in the Mathnasium franchise agreement:

> We also have the right to use up to ten percent (10%) of the annual aggregate Marketing Fees collected to pay for our administrative expenses attributable to the administration of our marketing program, including but not limited to prorated portions of our accounting, human resources, and real estate expenses.[35]

This provision is unusual in several respects. First, it is unusual to see a percentage limitation of how much of the fund can be used for administrative expenses. Second, the provision includes administrative expenses, such as real estate, that many may not typically consider as an expense to be allocated to the marketing fund. Whether it will end up benefitting the franchisor, at least the provision is clear, hopefully helping both franchisors and franchisees to avoid disputes that may lead to litigation about administrative expenses.

D. No Pro Rata Spending

Franchisees' biggest gripe with respect to advertising funds—aside from periodically having to pay into them—is that often they do not see the value added to their particular unit(s). While buzzy marketing campaigns may capture public attention for the brand, franchisees that do not see a corresponding increase in sales or profits may question whether they are receiving a direct benefit from their contributions. When the franchisor (or the cooperative) controlling the fund decides not to advertise in particular markets, franchisees may feel especially forsaken.

Some locations in a franchise system may be located in urban locations, while others are in suburban or rural areas. Some are well-established, while others are just starting out. Some operate in affluent areas, others in areas that struggle economically. Yet, national marketing funds are typically preparing programs for the "franchise family" at large. These programs may be of different level of importance and benefit for different franchisees. From a practical standpoint, it would be crippling for any marketing fund to try to make sure that an amount spent in each franchisee's location is equal to each franchisee's contribution. To avoid disputes about the fairness of the local impact and spend of the marketing fund fees, most franchise agreements will clarify that no promise is made to the franchisees about them receiving a pro rata share of the spend. The provision typically reads something like:

> Franchisee acknowledges that the intent of the Marketing Fund shall be to maximize general public recognition, direct sales programs, and acceptance of the Brand Hotels and Marks for the benefit of the Business System, and Franchisor shall have no obligation in administering the Marketing Fund, to make expenditures

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[35] Mathnasium Center Licensing, LLC, FDD, Section 5.3 (c) of Franchise Agreement (Mar. 4, 2020), available at Wis. Dept. of Fin. Insts., https://www.wdfi.org/apps/FranchiseSearch/MainSearch.aspx.

> for Franchisee which are equivalent or proportionate to any payments by Franchisee, or to ensure that any particular Franchisee or any particular franchised location benefits directly or pro rata from advertising or promotion conducted under the Marketing Fund.

Courts will generally uphold provisions like the one above. For example, in *JMF v. Medicine Shoppe*,[36] the U.S. District Court for the District of North Dakota reviewed a similar provision when a franchisee complained about the changes the franchisor was making to the franchise system, including the marketing for the brand. One of the franchisee's claims was that the franchisor had provided insufficient local marketing support. The court, relying on provisions that made it clear that Medicine Shoppe had sole discretion over the marketing fund, told the franchisee to swallow the bitter pill and granted the franchisor's motion for summary judgment.[37]

Similarly, in *Gregory v. Popeyes,* the franchisee operating the first six Popeyes restaurants in the Detroit area complained that the franchisor failed to advertise locally to support the restaurants and to fend off competitors.[38] In affirming the district court's dismissal, the Sixth Circuit found the franchisee's allegations too spicy and held that the franchisee failed to establish a prima facie case of breach of contract:

> Whether [franchisee's] stores directly received $925,000 worth of Detroit area newspaper, television and other media advertising is not the question; under the franchise agreements, Popeyes was not obligated to allocate [franchisee's] payments to Detroit area advertising. [Franchisee] utilized Popeyes' services and name during the period involved, and it had an interrelated, dependent obligation to make the prescribed payments for these services, even though the services were not as extensive or 'helpful' as [franchisee] desired.[39]

Both courts found in favor of the franchisor based on language that is similar to that in many franchise agreements: "Franchisor accordingly undertakes no obligation to insure than any individual franchisee benefits directly or on a pro rata basis from the placement, if any, of such advertising in his local market."[40] Other courts have relied on the *Gregory* decision in finding that similar complaints by other franchisees were overcooked.[41] While it is good news for franchisors that broad marketing fund provisions in franchise agreements are upheld by courts, the expense

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[36] JFM, Inc. v. Medicine Shoppe Int'l, Inc., No. 3:09–cv–73, 2011 WL 4369475 (D.N.D. Sept. 19, 2011).

[37] *Id.* at *7.

[38] Gregory v. Popeyes Famous Fried Chicken & Biscuits, Inc., No. 87-1461, 1988 WL 93303 (6th Cir. Sept. 9, 1988) (unpublished).

[39] *Id.* at *4.

[40] *Id.* at *2.

[41] America's Favorite Chicken Co. v. Cajun Enters., Inc., 130 F.3d 180 (5th Cir. 1997) (affirming summary judgment dismissal of breach of contract claim based on alleged failure to allocate sufficient advertising funds to local market); Biscuit Invests., Inc. v. Cajun Enters., Inc., No. 89–2778, 1991 WL 42584 (E.D. La. Mar. 27, 1991) (granting motion to dismiss franchisee's claim that franchisor failed to advertise in local market); Al Copeland Enters., Inc. v. Jamplis, No. 90–4902, 1991 WL 49651 (E.D. La. Apr. 3, 1991) (same).

of time and money inherent in any dispute should not be disregarded. Neither should the fact that the matter is likely to end up in the FDD litigation disclosure section.[42]

E. Franchisor Liability for Alleged Misappropriation of Marketing Funds

As recently as February 2020, Tim Hortons' U.S. franchisees brought suit against their franchisor and its corporate affiliates in federal district court for charging operational and administrative expenses to the advertising fund that allegedly bore no relation to advertising.[43] The operative complaint lists several examples of misappropriations, the salaries of non-advertising employees previously paid through general operating expenses, and costs related to franchisee training and evaluation, research and development, customer service, and private label products sold in grocery stores.[44] Although Tim Hortons is required to provide audited financial statements of the advertising fund, the franchisees allege that they have not been forthcoming since 2017.[45] The complaint is the latest battle in a long-simmering, cross-border war within the system in which U.S. and Canadian franchisees have sued their franchisors for allegedly charging unreasonable rates for food and supplies and unfairly restricting sales of restaurants.[46] At the time of publication, various defendants have filed motions to dismiss on jurisdictional grounds. Given that franchisees contribute approximately $28 million annually to the advertising fund, this case certainly warrants monitoring.

As the *Tim Hortons* case plays out, there are several important cases involving alleged misappropriation of advertising funds that will guide the litigants and the court. The most noteworthy and tumultuous case is *Broussard v. Meineke*, in which franchisees alleged that the franchisor formed and operated an in-house agency to utilize the advertising fund for its own benefit by, *inter alia*, charging inflated or fabricated advertising fees, accepting "kick-backs" from advertisers, and purchasing advertising that did not benefit franchisees.[47] The franchisees, suing as a class, asserted various contract, statutory, and tort claims, including breach of fiduciary duty. The franchisees argued that the special advertising obligations and duties constituted a fiduciary duty, with the franchisor acting as an agent of the advertising fund.

The federal district court certified the franchisee as a class, and, following a seven-week trial before a jury that rendered a verdict against the franchisor, entered final judgment in favor of

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[42] 16 C.F.R. § 436.5(c)(ii) (2007).

[43] Second Amended Complaint for Declaratory Relief at ¶¶ 60-71, *Great White North*, No. 20-cv-20878-BB (June 25, 2020 S.D. Fla.).

[44] *Id.* at ¶ 69. The relevant section of the franchise agreement states that the Advertising Fund shall not be used to defray any of the Franchisor's general operating expenses, except for the reasonable costs and overhead, if any, incurred by the Franchisor in activities related to the administration or direction of the Advertising Fund and advertising programs. *Id.* at ¶ 65.

[45] *Id.* at ¶ 66.

[46] Jonathan Maze, *Tim Hortons' U.S. Franchisees Accuse the Brand of Intimidation*, RESTAURANT BUSINESS, (July 2, 2019) https://www.restaurantbusinessonline.com/financing/tim-hortons-us-franchisees-accuse-brand-intimidation.

[47] *Broussard*, 155 F.3d at 334–35 (4th Cir. 1998).

the franchisees for a staggering $390 million, largely based on punitive damages.[48] Yet the Fourth Circuit muffled the jury verdict and court judgment by reversing and remanding the case back for the district court to deal only with the breach of contract claims.[49] The Fourth Circuit held that it was error to allow the franchisees to advance their breach of fiduciary duty claim because "[t]he near-universal rejection of imposing fiduciary duties in the franchise setting reflects a recognition that these obligations are out of place in a relationship involving two business entities pursuing their own business interests, which of course do not always coincide."[50] Courts from other jurisdictions have similarly dismissed tort claims to focus on contract claims and held that franchisors' administration of advertising funds did not create a fiduciary relationship, even where franchisors' representatives made additional statements.[51]

Perhaps nothing draws the ire of franchisees more than the perception that corporate-owned outlets are somehow receiving preferential treatment. In *Sunshine Restaurant Partners v. Shivshakti One*, a master franchisee in the International House of Pancakes ("IHOP") system sued the sub-franchisee for failure to pay royalty and advertising fees.[52] The sub-franchisee flipped the script and counterclaimed that the master franchisee initiated a cooperative marketing campaign, enticed sub-franchisees within the geographic region to vote in favor of the campaign, required the sub-franchisees to contribute to it, and then used the funds for only promoting the master franchisee's own restaurants.[53] While the agreement gave the master franchisee "undoubtedly broad" discretion to spend advertising funds, the federal district court denied its motion to dismiss because the sub-franchisee had made a cognizable argument that the agreement was internally inconsistent and not in keeping with the parties' intent.[54] The parties later settled in mediation, so the breadth of the master franchisee's discretion was never fully adjudicated.[55]

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[48] *Id.* at 336–37. The fact that the franchisor made repeated statements over the years that it held advertising dollars in trust likely influenced the jury. William L. Killion & Brian D. Schnell, *Franchisors as Fiduciaries in Handling Marketing Dollars: Whose Money Is It Anyway?*, 17 FRANCHISE L.J. 37, 55 (1997).

[49] *Broussard*, 155 F.3d at 345–46 ("At bottom then, this lawsuit centers on a dispute between Meineke and its franchisees over the interpretation of different [franchise agreements] and over Meineke's performance under [them]. This is a straightforward contract dispute, yet it somehow managed to become a massive tort action in the end.").

[50] *Id.* at 348.

[51] *See, e.g.*, Cottman Transmission Sys., LLC v. Kershner, 536 F. Supp. 2d 543 (E.D. Pa. 2008) (granting franchisor's motion to dismiss claims sounding in tort, including breach of fiduciary duty); Collins v. International Dairy Queen, 54 F. Supp. 2d 1351 (M.D. Ga. 1999) (letter from franchisor's vice president of marketing and statements by other executives, which referred to fiduciary relationship and promised that franchisor would "look out for best interests" of franchisees, were insufficient to create fiduciary relationship); Oil Express Nat'l, Inc. v. Latos, 966 F. Supp. 650 (N.D. Ill. 1997) (dismissal appropriate where "[franchisees'] claim for breach of fiduciary duty rests on the mere trust it placed in [franchisor] to fulfill its contractual duties. This is not enough to create a fiduciary duty.").

[52] Sunshine Rest. Partners, L.P. v. Shivshakti One, Inc., No. 08–22332–CIV, 2008 WL 4809096 (S.D. Fla. Nov. 5, 2008).

[53] *Id.* at *2.

[54] *Id.* The court granted the master franchisee's motion to dismiss the counterclaim for breach of the implied covenant of good faith and fair dealing. *Id.* at *3.

[55] Report of Mediation, *Sunshine Rest. Partners*, (No. 08–22332–CIV).

Political and social issues have a way of inflaming passions, and franchising is no different, particularly when advertising funds are used to promote a particular cause. When Burger King brought suit to terminate a franchisee operating four restaurants for repeated quality assurance defaults, the franchisees cooked up a Whopper in their counterclaims, alleging that Burger King's donation of $5 million to the American Red Cross from the advertising fund was a breach of the implied covenant of good faith and fair dealing. Burger King's argument that the donation was part of a legitimate public relations effort for which it received positive publicity persuaded the court to grant summary judgment in its favor.[56]

While a donation to a nonpartisan health organization is relatively uncontroversial, franchisors' promotion of social issues sometimes receives a chilly reception by franchisees. For example, a Ben & Jerry's franchisee alleged that the franchisor misused advertising money paid by franchisees to fund its (arguably well-known)[57] political agenda rather than sell ice cream.[58] Although the franchise agreement granted Ben & Jerry's sole discretion over the concepts, materials and media used in market programs, the federal district court denied Ben & Jerry's motion to dismiss because the franchisee's contention that the political programs did not constitute advertising was sufficient to state a claim for breach of contract.[59] The parties' frozen relations later thawed and they reached a settlement to dispose of the case.

In the same "Is that marketing?" vein, franchisees challenged Little Caesar's use of $670,000 in marketing funds to sponsor a Detroit arena football team owned by Little Caesar's primary owner and $200,000 to pay a former executive to sponsor his racing boat that appeared in national televised competitions.[60] The federal district court sliced up the franchisees by refusing to certify them as a class for this breach of contract and conversion claim, and the parties left this tasty question unanswered by later deciding to Settle! Settle![61]

While many of the above cases ended up settling, this only happened after both franchisor and franchisee expended significant funds and resources on fighting each other. Litigation rarely results in improved relationships between the litigants, and finding middle-ground before a dispute arises may save not only time and money, but also the relationship itself.

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[56] Burger King Corp. v. Agad, 941 F. Supp. 1217 (1996)

[57] *See* Steffanee Wang, *The History of Ben & Jerry's Progressive Politics*, PACIFIC STANDARD (June 14, 2017) https://psmag.com/news/the-history-of-ben-jerrys-progressive-politics.

[58] Sherman v. Ben & Jerry's Franchising, Inc., No. 1:08-CV-207, 2009 WL 2462539 (D. Vt. Aug. 10, 2009). The franchisee cited as particularly divisive Ben & Jerry's "Waffle Truth" campaign that directed customers to Al Gore's website and encouraged them to buy his book or DVD. *Id.* at *1.

[59] *Id.* at *7. The parties later reached a settlement to dispose of the case. ENE Letter, *Sherman*, 2009 WL 2462539 (D. Vt. Apr. 13, 2010) (No. 126).

[60] Little Caesar Enters., Inc. v. Smith, 895 F. Supp. 884, 889 (E.D. Mich. 1995).

[61] *Id.* at 906.

IV. FRANCHISOR CONTROL AND FRANCHISEE INPUT: I SHOULD HAVE A SAY IN HOW "MY" MONEY IS SPENT

As discussed in Sections II and III, supra, disclosure documents and franchisee agreements should clearly lay out the decision-making process regarding advertising and marketing funds to franchisees. Since franchisors typically own the trademarks that are essential to their brands, they will naturally seek to control their use in advertising and marketing. This issue nevertheless presents franchisors with an opportunity to consider strategic and cultural factors regarding how much and what kind of valuable input they wish to receive from their franchisees, which interact daily with customers and are also motivated to have the brand succeed. The structure and nature of the collaborations are as varied as the advertisements and marketing campaigns of franchise systems. As Burger King famously told its customers: "Have it Your Way!"

A. <u>Advisory Roles of Franchisees</u>

At the franchisee-friendly end of the continuum, franchisees in the AAMCO system select 15 of the 18-member National Creative Committee ("NCC"), which determines the amount of the contribution to the National Creative Advertising Fund, selects the advertising agency and approves the commercials made.[62] Lest the franchisor try to throw sand in the gears regarding how fund money (over $1 million collected in 2019) is spent, Item 11 states clearly that the Chairman of the NCC is always an AAMCO franchisee and that AAMCO does not control the decisions of the NCC.[63]

Franchisees in the much larger KFC system seemingly play a dominant role in decisions about advertising. The KFC National Council and Advertising Cooperative, Inc. (known as the National Co-Op), is a non-stock corporation that was founded over more than fifty years ago with the purpose of "administer[ing] national advertising for outlets."[64] Its governing committee is comprised of seventeen voting members: four appointed by KFC, twelve elected by region by franchisees, and one who is the President of the franchisee association. Franchisees undoubtedly find their 13-to-4 advantage "Finger Lickin' Good," but there nevertheless exists a chicken-or-egg question regarding ultimate control over advertising. The National Co-op also has a sub-committee, known as the Brand Committee, which appears to tip the balance of control back towards the franchisor. The Brand Committee has "oversight and approval of matters related to national advertising and marketing" and is comprised of five voting members, three franchisor representatives and two franchisee representatives, who all must also serve on the governing committee.[65]

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[62] AAMCO Transmissions, LLC FDD, (Mar. 20, 2020), Item 11, p. 35, available at Wis. Dept. of Fin. Insts., https://www.wdfi.org/apps/FranchiseSearch/MainSearch.aspx.

[63] *Id.*

[64] KFC US, FDD, (Mar. 20, 2020), Item 11, p. 27, available at Wis. Dept. of Fin. Insts., https://www.wdfi.org/apps/FranchiseSearch/MainSearch.aspx.

[65] *Id.*

A variation of this structure was the subject of litigation a decade ago when KFC proposed, *inter alia*, to feature healthier grilled chicken in an advertising program over the usual fried chicken.[66] The National Co-op sought a declaration that the governing committee had the "ultimate authority" with respect to advertising programs. According to the incorporation certificate in effect at the time, KFC's roles were to "develop national advertising, public relations media and strategy, including advertising and media calendars and budget, and submit such plans for the approval of the [governing] Committee" and "recommend any changes in the advertising and media calendars and budget which it deems appropriate, which changes can only be implemented with the approval of the [governing] Committee."[67] A separate section granted the governing committee the right to "plan and approve each ensuring year's advertising program within the limits of an estimated budget" developed by KFC.[68] Since these provisions were "internally contradictory and overlapping," and thus ambiguous, the Delaware Chancery Court considered extrinsic evidence that the governing committee had approved advertising proposals over KFC's objection in the past. The court concluded that KFC "has primary responsibility to make recommendations to the [National Co-op] for the [governing] committee's approval but that the [National Co-op] retains the authority to make recommendations and then vote on those recommendations by majority rule."[69] The court further noted that "KFC's fears are mitigated by the fact that KFC remains the owner of the KFC brand and its associated trademarks,"[70] and also pointed out that franchisees, just like the franchisor, have a vested interest in being good shepherds for the brand, and that both parties stand to win from listening and learning from each other.

At the other, franchisor-friendly end of the continuum—which is far more common than KFC's arrangement—a franchisor may retain sole discretion to use advertising funds in any way that it sees fit. For example, if you are a franchisee in the Hardee's system potentially looking to influence its marketing direction, you will be unlikely to "Feed Your Happy" based on the following language:

> We have established, and will maintain and administer, HNAF [Hardee's National Advertising Fund] for the creation and development of advertising, marketing and public relations, research and related programs, activities and materials that we our sole discretion, deem appropriate…. There is no franchisee advertising counsel that advises [franchisor] on advertising policy…. We or our designee direct all advertising, marketing, and public relations programs and activities financed by HNAF with sole discretion over the creative concepts, materials and

[66] *KFC Nat'l Council*, Bus. Franchise Guide (CCH) ¶ 14,542. A review of KFC's FDD applications reveals that the Brand Committee was introduced in 2017.

[67] *Id.* at 7.

[68] *Id.* at 7–8.

[69] *Id.* at 19.

[70] *Id*.

> endorsements used in those programs and activities, and the geographic, market and media placement and allocation of advertising and marketing materials.[71]

Franchisees that had closed a restaurant early tested this seemingly airtight language when they asserted a counterclaim against Hardee's for breach of contract and the covenant of good faith and fair dealing and alleged that Hardee's "failed to deliver to [franchisees] a viable franchise concept and a reasonable opportunity to succeed" because it had, *inter alia*, "denigrated the Hardee's brand image" by "running the lewd television ads" featuring Paris Hilton.[72] The franchisees survived Hardee's motion to dismiss when the federal district court held that they may be able to establish that Hardee's exercised its duties and discretion related to the advertising fund in a way that denied the franchisees the expected benefit of the contract.[73] Yet the franchisee's "Happy Star" moment was fleeting because the court granted Hardee's motion for summary judgement a year later, holding that "the record establishes that [Hardee's] made a strategic marketing decision and approved the ads at issue in what it believed was the best interests of the Hardee's brand, which is what the Agreement with the [franchisees] contemplated that [Hardee's] would do."[74] Depending on the language of the franchise agreement, franchisee challenges to the content of the advertising campaigns may be able to survive the pleading stage, but may ultimately prove unsuccessful after discovery.

While the KFC and Hardees systems represent opposite ends of the continuum, many franchisors will retain control of marketing and advertising, but allow franchisees a mechanism to provide valuable input. For example, Choice Hotels provides its franchisees some comfort that their voices will be heard: "We administer the allocation of the [advertising fund], although recommendations by our franchisee associations with respect to our marketing and reservations are considered."[75] Some systems may decide to set up some kind of advisory council or committee specifically for advertising, with its membership and duties laid out in the franchise agreement.

Another middle-ground example is the Planet Fitness system in which the franchisor subtlety flexes its muscles by stating that it "may seek the advice of owners of PLANET FITNESS businesses by formal or informal means with respect to the creative concepts and media used for programs financed by the [marketing fund]. We generally do so through the marketing

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[71] Hardee's Rests., LLC Application for Renewal with proposed FDD, (May 25, 2018), Item 11, p. 38–39, available at Minn. Commerce Dept., https://www.cards.commerce.state.mn.us/CARDS/.

[72] Hardee's Food Sys., Inc. v. Hallbeck (*Hardee's I*), 776 F. Supp. 2d 949, 951 (E.D. Mo. 2011). *See also* Eric Noe, *How Well Does Paris Sell Burgers?*, ABC NEWS (Jan. 6, 2006), https://abcnews.go.com/Business/story?id=893867.

[73] *Hardee's I*, 776 F. Supp. 2d at 953.

[74] Hardee's Food Sys., Inc. v. Hallbeck (*Hardee's II*), No. 4:09CV00664 AGF, 2012 WL 13055688, at *5 (E.D. Mo. Feb, 28, 2012). The court ultimately ordered the franchisees to pay Hardee's $250,000, which included attorneys' fees. Judgement with Attached Settlement Agreement, *Hardee's II*, 2012 WL 13055688 (E.D. Mo. Mar. 14, 2012) (No. 214).

[75] Choice Hotels Int'l, Inc., FDD (Apr. 1, 2020), Item 11, p. 58, available at Wis. Dept. of Fin. Insts., https://www.wdfi.org/apps/FranchiseSearch/MainSearch.aspx.

subcommittee of the elected franchisee council, though we may seek advice in a different manner in the future."[76] The marketing subcommittee is chosen by the elected franchisee council.

B. Different Types of Cooperatives: National, Regional, and Local

All politics is local. So, too, with advertising to attract customers to local franchise outlets. Moreover, state-specific laws and regulations applicable to certain franchised businesses may also require state-specific advertising. Even marketing campaigns that play well in the Northeast region of the United States with its long winters may not be appreciated as much in the desert Southwest region. Iced coffee, anyone?[77]

Recognizing the need for advertising dollars to be spent in adaptive ways in different markets, some franchises systems have developed what are known as regional and local advertising cooperatives. If such funds are created, Item 11 requires the franchisor to disclose a substantial amount of information regarding them, including, *inter alia*, a definition of the area covered, the governance and administration of the cooperative, and franchisees' required contributions.[78]

In the Massage Envy system, for example, franchisees must contribute 2% of their gross sales to a Marketing Fund, over which the franchisor maintains "complete control."[79] This language is hardly a stretch given the examples in the prior section. Yet in 2017, a majority of franchisees voted to create a national advertising cooperative governed by a committee comprised of six members appointed by the franchisor and six members appointed by the franchisees. The committee has the power to approve, by at least nine members, all annual marketing plans of the national cooperative and mandate franchisee contribution levels, which are above and beyond the mandatory 2% Marketing Fund.[80] Since franchisees are required to spend a minimum of 6% of annual gross sales on some form of advertising, marketing and promotional programs—with credits for contributions to the Marketing Fund and the national cooperative—franchisees have dug deep and found a way to have a meaningful say in how a majority of those funds are spent, with some oversight by the franchisor.[81]

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[76] Planet Fitness Franchising LLC FDD (June 29, 2020), Item 11, p. 41, available at Wis. Dept. of Fin. Insts., https://www.wdfi.org/apps/FranchiseSearch/MainSearch.aspx.

[77] Although not a franchise system, Starbucks analysts noted significant regional differences in customer preferences. *See* Roberto A. Friedman & David Yanofsky, *What People Order at Starbucks Around the United States*, QUARTZ, (Apr. 4, 2014) https://qz.com/195631/what-people-order-at-starbucks-around-the-united-states/.

[78] 16 C.F.R. § 436.5(k)(4)(iv) (2007).

[79] Massage Envy Franchising, LLC FDD (Apr. 30, 2019), Item 11, p. 32–33, available at Wis. Dept. of Fin. Insts., https://www.wdfi.org/apps/FranchiseSearch/MainSearch.aspx.

[80] *Id.* at 34. The National Coop 2019 Annual Plan provides for annual franchisee contributions to the National Coop ranging from approximately $1,100 to $1,500 determined, at least partially, according to each franchisee's 2018 gross sales. *Id.*

[81] *Id.* ("Franchisees may be required to spend more than the Minimum Marketing Spend Requirement because required ME National Marketing Cooperative contributions must be fulfilled even if it means exceeding your Minimum Marketing Spend Requirement.").

Like other systems, Massage Envy provides for the establishment of regional advertising cooperatives.[82] Once organized, the franchisees and franchisor-owned outlets in the geographic area become members responsible for the regional cooperative's administration and determination of contribution levels. All material decisions at mandatory monthly meetings require an affirmative simple majority vote documented by minutes.[83] Massage Envy recommends—but does not mandate—that regional cooperatives operate according to written documents and prepare periodic financial statements available to its members. The franchisor further reserves the right "form, change, dissolve, or merge" the regional cooperatives at its sole discretion.[84]

Rules on regional cooperatives in the Hardee's system, by contrast, are small on governance details and extra-large on franchisor discretion and control:

> Franchisee shall be a member of and contribute to the Regional Co-op such amount as is determined from time to time by [Hardee's] and/or the Regional Co-op…. The Regional Co-op may be incorporated by [Hardee's] and will be operated in accordance with its charter, which [Hardee's] shall have the right to modify from time to time in its sole discretion.[85]

Even with Hardee's desire to control all aspects of advertising, it still grants franchisees some discretion regarding how to spend advertising dollars locally. In the 2018 franchise agreement, franchisees were required to spend at least 1.25% of gross sales in their local market (less, if they were required to contribute to the Regional Co-op).[86] Of course, the advertising and sales promotional materials must be approved by the franchisor, but franchisees can be flexible in how they spend advertising dollars closest to their stores. More broadly, a 2017 study by a media analyst revealed that 65% of franchisees surveyed use cooperative dollars for advertising and promotion, with more than one-third reporting that up to half of their marketing spending comes from cooperative dollars.[87]

In keeping with its brand name, Choice Hotels allows its franchisees to voluntarily opt into the thirteen regional marketing cooperatives each year.[88] Each regional cooperative establishes an annual fee for participating hotels, and the franchisor also provides funding. The franchisees

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[82] *Id.* at 35.

[83] *Id.*

[84] *Id.*

[85] Hardee's Rests., LLC Application for Renewal of FDD with Franchisee Agreement, (May 25, 2018), Section 5C, p. 9, available at Minn. Commerce Dept., https://www.cards.commerce.state.mn.us/CARDS/.

[86] *Id.* at Section 5D.

[87] *Majority of Franchisees Use Co-Op Dollars for Advertising & Promotion*, BIA ADVISORY SERVICES (Mar. 16, 2017), http://www.biakelsey.com/majority-franchisees-use-co-op-dollars-advertising-promotion-according-new-biakelsey-report/.

[88] Choice Hotels Int'l, Inc., FDD, (Apr. 1, 2020), Item 11, p. 58, available at Wis. Dept. of Fin. Insts., https://www.wdfi.org/apps/FranchiseSearch/MainSearch.aspx.

participating in the regional cooperative, along with the assistance of a franchisor representative, create an annual budget and an annual marketing plan.[89]

C. Structuring of Councils, Committees, and Cooperatives

Regardless of the form of the franchisee entity that is tasked with advising and/or making decisions about marketing, consideration should be given to how diverse franchisee voices may best be heard. For example, in large, mature franchise systems spread all over the United States, franchisees may be chosen from different geographic regions already established by the franchisors. Seats may also be reserved for franchisees from urban, suburban, and rural markets because their customers tend to have similar social-economic backgrounds and spending habits, regardless of the region in which they live. Operators of multiple franchises with large amounts of capital invested will want to give input and have influence, especially if they are backed by private equity and professional pedigrees; however, operators of single units who invest their personal wealth should not be ignored as they are often in the stores interacting directly with customers. Imposing term limits and rotating franchisees in and out of positions will infuse new and insightful ideas in to the process, as will reserving spaces for minority franchise owners who often live in the same communities and share the same experiences as their customers.

V. FUND MANAGEMENT IN COMPLEX FRANCHISE SYSTEMS: DON'T TELL ME I WOULDN'T UNDERSTAND

A. Mature Systems with Different Marketing Fund Provisions in Different Agreements

As franchise systems grow and develop, their franchise agreements must undergo corresponding change. The marketing fund provision in those agreements is no exception. The result is often that franchisees in the same system have different marketing fund provisions in their franchise agreements. Sometimes the differences among contractual provisions are innocuous, with newer provisions simply being more detailed than the older ones, but sometimes they can lead to some real headaches. For example, what should a franchisor do if the marketing fund provision in older forms of franchise agreements are very specific about the type of expenses permitted and it is reasonably clear that social media and app development is not within the scope of permitted spending? What if the older agreements require franchisees to be part of the decision-making marketing fund committee, where newer agreements specify that the committee will only consist of franchisor's own employees? What if the franchisor acquired a second brand and wants to conduct joint marketing campaigns for the two brands?

The franchisor's actions in these and countless similar situations will depend on a number of factors. For example, in a large system, if most franchisees are still on the older form of franchise agreement that clearly excludes social media spending, the franchisor may have to accept that, for the time being, it will have to pay for social media marketing out of funds separate from the marketing fund. If it is a smaller system, or if only a small number of franchisees are on the older form of agreement, it may be worth seeking those franchisees' express consent to social media spending through an amendment to the franchise agreement. If the franchisor is in a position to offer some type of incentive to franchisees, it may condition the grant of the incentive on the franchisees amending their franchise agreement to incorporate the newer marketing fund

[89] *Id.*

provision. To the extent the provision in the older agreements is just somewhat unclear, a franchisor may just also want to take a calculated risk and spend the fund on social media, with or without input from an advisory franchisee committee or the franchisees on the older form of agreement. The relationship between the franchisor and the franchisees on the older form of agreement should also impact the franchisor's course of action.

If the older agreements provide for a different form of marketing fund management, some of the solutions enumerated above may not work. The franchisor cannot just ignore the provision in the older agreement, with or without the input of advisory franchisee committees. If there are a very small number of franchisees on the older form of agreement, negotiating an amendment may be an option, but that will also be difficult. In the social media example, the change would be to include a modern form of advertising that is a given for most businesses today. A franchisee refusing to amend their agreement may almost seem unreasonable. On the other hand, if the change to the marketing fund is to take away decision-making rights from a franchisee and put all the power on the franchisor, a franchisee's hesitance and potential refusal to an amendment can be understandable.

One possible solution, which may appear drastic, is for the franchisor to set up separate marketing funds for the different agreements. Especially where the scope of the provision is similar and the main issue is the management of the fund, this could be a good solution.[90] In that situation, the fact that different franchisees are paying into different funds may be nothing more than an administrative hassle. The separate funds may even enter into a joint management agreement where the management committees agree to operate the funds jointly. A joint management approach will require good will from both the franchisor and franchisees at large and, in some systems it may just be easier to amend the older franchise agreements. However, if there are a few franchisees with older agreements that would try to take advantage of the need for amendment to demand unreasonable concessions, this solution may work, as long as they are in a minority.

Yet having separate marketing funds is typically a band-aid solution. Over time, the franchisor should try to get all franchisees to sign the new form of agreement. Renewals and transfers are natural points in time when the franchisor can update the form of agreement. But a franchisor could also seek out other opportunities to do so earlier. For example, if a franchisee is asking for a concession, the grant of the concession could be conditioned on the execution of a new form of agreement. Likewise, if the franchisor is rolling out an incentive program of some sort, it can condition it on franchisees being on the new form of agreement.[91]

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[90] If the separate marketing fund option is chosen to take advantage of a broader scope of a newer marketing fund provision, franchisors should be careful. The result will be that some marketing programs are paid for by only the "new form agreement locations," while the "old form agreement locations" may also be benefiting. Though it may be completely within the franchisor's right to fund certain forms of marketing and advertising this way, uneven contributions to the franchise system marketing may breed resentment which in turn is likely to lead to conflicts.

[91] The types of concession vary. In the current, COVID-19 climate it could be a condition to obtaining fee forgiveness or deferral, but under any circumstances it may be a condition to participating in a new program, for obtaining an extension of remodeling obligations, or for obtaining anything else of value that the franchisor can give its franchisees.

B. <u>Different Fees for Different Franchise Models</u>

A franchisor should also consider whether it wants to collect advertising fees from all locations. Depending on its business model and other strategic considerations, the franchisor may decide that specialized or non-traditional franchisee locations should contribute less or no money at all to the advertising fund. For example, Dunkin' requires franchisees with restaurants in certain captive audience locations (*i.e.*, hospitals, train stations, airports, etc.) or those located within another host establishment, such as a stadium or another retail facility, to contribute at a reduced rate.[92] These types of outlets logically do not benefit as much from marketing because their customers are attracted to the location for other reasons and, once there, have few alternative options. Relatedly, a franchisor looking to expand into new regions may decide to have new franchisees in those areas contribute at a lower percentage until the regions reach a certain number of locations.

Nevertheless, such exceptions to the general rule of contributing to the marketing fund should be considered carefully because a franchisor may expose itself to claims of disparate treatment. In *Hall v. Burger King*, Hispanic sub-franchisees asserted discrimination on the basis of race against the franchisor for, *inter alia*, charging them one-half percent more than it charged other franchisees for rent, royalties and marketing contributions.[93] The court granted summary judgment to Burger King on the grounds that the extra one-half percent reflected the profit margin to the franchisee from whom the sub-franchisee purchased their locations, which itself was contractually obligated to pay rent, royalties and marketing contributions to Burger King.[94] This case is somewhat unusual because the discrimination alleged here was racial in nature and the sub-franchisees invoked federal civil rights laws; however, as noted above in Section II.B., Arkansas, Illinois, Indiana, Hawaii, Minnesota, and Washington have enacted statutes protecting from franchisees from discrimination generally.

VI. MULTI-BRAND ADVERTISING FUNDS: YOU CANNOT SPEND "MY" MONEY ON OTHER BRANDS

A. <u>Joint Marketing Projects for Different Brands</u>

Joint marketing projects for different brands owned by the same or affiliated franchisors can arise in at least two different settings. First, it is possible for a franchisor to operate one joint marketing fund for several brands. Second, a franchisor may operate separate marketing funds for the different brands, but have each fund contribute to joint marketing projects.

The marketing fund disclosure requirements are discussed more fully in Section II of this paper, but there is no specific FDD disclosure requirement relating to multi-brand advertising. However, for most of the marketing fund and advertising co-op-related disclosures, if the franchisor intends to combine the marketing for its different brands, disclosure may be a natural

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[92] Dunkin' Donuts Franchising LLC, FDD (Mar. 27, 2020) Item 11, page 52 available at Wis. Dept. of Fin. Insts., https://www.wdfi.org/apps/FranchiseSearch/MainSearch.aspx.

[93] Hall v. Burger King Corp., 912 F. Supp. 1509, 1531–34 (S.D. Fla. 1995).

[94] *Id.*

consequence of that circumstance, or it may make sense to mention the joint efforts in the FDD. For example, if there is only one marketing fund for multiple brands, or there will be one franchisee council for several brands, the joint nature of those undertakings will be part of the required FDD disclosures: members of the franchisee council must be disclosed[95] and the same is true about contributors to the marketing fund.[96] Though technically not required, it is also advisable for a franchisor to at least mention the possibility of the marketing fund being spent in some part on other brands. Whether factually correct or not, franchisees may perceive that the spending from a joint fund or on joint projects unfairly favors franchisees of the other brand(s). This perception is likely to be stronger if the franchisee believes the franchisor was hiding its marketing plans from the franchisee.

Complete fairness is difficult to achieve amongst franchisees of one system, and it is that much harder to do that when several brands are involved. When brands have co-existed for a long time it may be less of an issue, but mergers and acquisitions of competing franchise systems can engender resentment among franchisees, particularly where advertising funds are involved. After Popeyes merged with Church's Fried Chicken in 1989, the Detroit market once again boiled over when Popeyes franchisees sued the franchisor alleging that a "dual marketing strategy" favored Church's and did not lessen the competition between them.[97] The federal district court did not bite, however, and granted summary judgement in favor of the franchisor based on the franchise agreement quoted above in the *Gregory* case and uncontroverted evidence that "Popeyes and Church's maintain distinct marketing policies to which the other is not privy."[98] The court also noted evidence that the distinction between low and high market referred more to Church's as a value brand and Popeyes as a "flavor quality" brand, and that the franchisees themselves set prices.[99]

G.I. McDougal v. Mail Boxes Etc. involved another forced marriage of franchise systems in which the advertising fund became the subject of litigation.[100] In 2001, United Parcel Service ("UPS") purchased Mail Boxes, Etc. ("MBE") and convinced 87% of MBE franchisees to convert their businesses to The UPS Store. Three California holdout franchisees complained that MBE (UPS's subsidiary franchisor), *inter alia*, used funds to purchase advertising for The UPS Store instead of MBE outlets.[101] While the lower court granted summary judgment in favor of UPS and MBE, the state appeals court returned the case to sender, citing evidence that MBE reallocated $5 million from the national media fund (which earlier had been committed to advertising for the MBE brand) to advertise for The UPS Store instead. The appeals court also held that the franchisees created triable issues of fact regarding to what extent MBE controlled the national media fund and whether its subsequent termination and distribution back to franchisees was

[95] 16 C.F.R. 436.6(k)(4)(iii) (2007).

[96] 16 C.F.R. 436.6(k)(4)(v) (2007).

[97] Clark v. America's Favorite Chicken, 916 F. Supp. 586 (E.D. La. 1996), *aff'd,* 110 F.3d 295 (5th Cir. 1997).

[98] *Id.* at 590.

[99] *Id.* at 594.

[100] G.I. McDougal, Inc. v. Mail Boxes Etc., No. B196029, 2008 WL 2152911 (Cal. Ct. App. May 23, 2008).

[101] *Id.* at *10.

proper.[102] The appeals court even delivered an award to franchisees of their costs on appeal.[103] The advertising fund claim was later dismissed pursuant to stipulation before the case proceeded to trial on other claims.[104]

Another example of the conflicts that may arise can be found in the acquisition of the Heavenly Ham franchise system by the parent of its competitor, the Honey Baked Ham ("HBH") brand. Several lawsuits followed the acquisition, but *Hanson Hams v. HBH* shows, in colorful language, what the acquisition looked like from the franchisee's perspective.[105] When the HBH franchisor acquired Heavenly Hams, it gave Heavenly Ham franchisees three options, depending on their proximity of HBH locations: (1) continue operating under the Heavenly Ham brand, (2) rebrand to HBH, or (3) sell their locations to the new franchisor. Out of 185 Heavenly Ham locations, 52 were converted, sold, or closed. The franchisor also decided not to open any new Heavenly Ham locations. A franchisee that decided to continue to operate, but fared poorly, brought suit alleging that the operation of the two ham brands was in violation of the Florida Unfair and Deceptive Practices Act. More interesting than the outcome of the case—the franchisee lost—is how the franchisee portrayed the operation by franchisor of two competing brands. For example, the franchisee argued that the situation "pits franchise siblings against one another while placing the parent [Defendant] ... in a position where it can favor (and has favored) one franchise system over the other by way of promotion, development and support."[106] Claiming that the franchisor was hogging the market for the HBH brand, the franchisee claimed that the franchisor "has engaged in a systematic attempt to strangle the Heavenly Ham franchise system" and has "attempted to isolate [Plaintiff's] franchise in its market area in order to drive it out of business," with the end result that "the Heavenly Ham system is dying a slow death and [Plaintiff] dying with it."[107]

Though hyperbole can be expected in any litigation, the Heavenly Ham litigation nonetheless points to the difficulties that franchisors face when managing two or more brands. Franchisors with brand combinations need to ensure that locations in the systems do not get trampled in the general excitement about growth and new development opportunities.

Even when brands have long been under the same ownership, a franchisor will need to ensure that the franchise siblings are treated fairly in joint marketing efforts and that its franchise agreement provisions are broad enough to allow for such projects. The marketing fund provision of the WoodSpring brand (part of the Choice Hotels group), included above in Section III.C., for example, clearly states that the marketing fund will be used for marketing of the "Choice Brand Hotels." Multi-brand franchisors may want to add explicit disclaimers of pro rata spending per brand and otherwise draft their marketing fund provisions in ways that give them maximum flexibility.

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[102] *Id.*

[103] *Id.* at *14.

[104] G.I. McDougal, Inc. v. Mail Boxes Etc., Inc., No. B226112, 2012 WL 90083, at *2 (Cal. Ct. App. 3d Dist. Jan.12, 2012).

[105] Hanson Hams, Inc. v. HBH Franchise Co., LLC*,* No. 03-61198CIV, 2004 WL 5470401 (S.D. Fla. Dec. 21, 2004).

[106] *Id.* at *5.

[107] *Id.*

B. Allocation of Marketing Expenses Between Different Brands in Relation to Services Provided

Although presumably multi-brand franchisors will try to make sure each brand gets a reasonable return from the marketing fund marketing efforts, a franchisor must be prepared that the perception of what is fair and just will differ among the franchisor and the franchisees of different brands.

In its franchise agreement, the franchisor should consider including provisions that clarify that the franchisor makes no promises with respect to pro rata allocation of marketing funds among franchisees and their territories. In a multi-brand franchise agreement, the franchisor may wish to add provisions explaining that no promises are made regarding the pro rata allocation of the marketing fund between the different systems. Such a promise would be impossible to make because the number of franchisees, the territories covered, and the contributions from each brand's franchisees shift continuously, and, as such, it would not be practicable to allocate "fair" shares.

C. Lack of Transparency or Collaboration

Broad franchise agreement provisions giving the franchisor flexibility over the marketing fund spending typically win the day in court, but are often only marginally successful in keeping the franchisor out of court in the first place. Franchisors wishing to spend their time and money on non-litigation matters should consider whether greater transparency and collaboration with their franchisees is a better and cheaper option. Including franchisees in the decision-making process through an advertising committee will afford opportunities both for early feedback on marketing fund projects and create franchisee advocates for the programs adopted.

Franchisors taking charge of the relationship will usually have the opportunity to determine the form and extent of both transparency and franchisor-franchisee collaboration in their system. Where transparency is missing, or franchisees do not feel that they have a say in decisions affecting them, formation of an independent franchisee association may soon follow. Disputes—and the attendant costs in resolving them—often follow, which can lead to system-wide changes to the marketing fund and other franchise agreement provisions.

VII. PROCEDURAL ISSUES IN LITIGATION: I'LL SEE YOU IN COURT

A. Who Sues Whom and Who Pays?

In the most common scenarios in which the franchisee fails to pay the advertising fee or under-reports the metric upon which the advertising fee is based, the franchise agreement should indicate the franchisor's mechanisms for enforcement. Even where an independent marketing fund is created, the franchisor—which collects royalties and other fees from franchisees—is better positioned to issue notices of default and termination and initiate arbitration or litigation. Moreover, in the case of franchisees that do not pay royalties, marketing contributions, and other fees, consolidating the defaults into a single action is far more efficient for all parties involved.

Finally, depending on the legal status of the marketing fund and the drafting of contracts related to the fund, third-party beneficiary claims may arise in order to enforce rights.[108]

Many franchise agreements contain a provision whereby the prevailing party is entitled to recover reasonable attorneys' fees and legal costs incurred in successfully enforcing the agreement.[109] For those that do not—or in cases where the franchisee and any guarantor are judgment-proof—the issue arises whether the administrative cost of collection efforts may be charged directly to the marketing fund. For example, franchisees brought a putative class action for breaches of contract and the implied covenant of good faith and fair dealing against Dunkin' over its use of marketing funds to cover collection expenses.[110] The federal district court granted summary judgment in favor of Dunkin' because "[n]othing in the agreement specifically prohibits Dunkin' from exercising its discretion to allocate administrative to the Fund for loss prevention related to advertising (subject, of course, to the 20% cap.)"[111]

In many cases, the complaints of a single franchisee or a small group of franchisees regarding their franchisors' administration of marketing funds have been aired defensively in counterclaims after the franchisor has brought suit. Franchisee claims about misuse of marketing funds have been wrapped up with other financial grievances that threaten their businesses. Given the high legal costs, rarely does a single franchisee or a small group of franchisees take on the franchisor alone over just the advertising funds fees. Larger groups of franchisees from a particular geographic area or that have signed a specific form of franchise agreement may pool resources to file suit against their franchisors, the marketing fund (if a separate entity), the franchisors' corporate parents, and even executives. Disgruntled franchisees may also look to their independent franchisee associations to subsidize the cost of litigating their claims, especially where a positive outcome could reverberate throughout the system. More offensive actions usually require more coordination among larger groups of franchisees, as discussed below.

B. Class Actions and Standing of Franchisee Associations

Independent franchisee associations may assist their members by organizing, funding, and coordinating a class action or leading the effort to consolidate multiple aggrieved franchisees in a single action against the franchisor. Many modern franchise agreements expressly prohibit

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[108] *See* Kitchen Inv. Group, Inc. v. Buchtel Food, Inc., Bus. Franchise Guide (CCH) ¶ 12,755 (N.D. Ohio 2004) (where franchisee failed to make marketing contributions, franchisor was third-party beneficiary even though franchisee only signed contract with subfranchisor); Oil Express Nat'l, Inc. v. Latos, 966 F. Supp. 650, 652–53 (N.D. Ill. 1997) (franchisee was third-party beneficiary where franchisor allegedly failed to segregate and spend marketing monies contributed by supplier pursuant to separate contract).

[109] *See* KFC US, LLC, FDD, (Mar. 20, 2020), Ex. B, p. 20, available at Wis. Dept. of Fin. Insts., https://www.wdfi.org/apps/FranchiseSearch/MainSearch.aspx.

[110] *Moghaddam*, 322 F. Supp. 2d 44. The franchise agreement provided that only 1% of the 5% of gross sales collected in advertising fees could be used for advertising expenses. *Id.* at 46.

[111] *Id.* at 47–48. The corresponding section now reads: "We may use up to twenty percent (20%) of Continuing Advertising Fees but none of Additional Advertising Fees for the administrative expenses of the Fund and for programs designed to increase sales and further develop the reputation and image of the brand." Dunkin' Franchising, LLC, FDD, (Mar. 27, 2020), Ex. B-1, p. 172, available at Wis. Dept. of Fin. Insts., https://www.wdfi.org/apps/FranchiseSearch/MainSearch.aspx.

class actions and consolidated actions by franchisees, making this approach more challenging than other options for franchisee associations. Such class and group action bans have been upheld if embedded in an arbitration agreement.[112]

Assuming class actions are available to franchisees, the *Broussard* decision underscores the challenges franchisees face in establishing the commonality and typicality of their claims. The Fourth Circuit noted five different factual and legal arguments that doomed their certification:

1. Franchisees signed different franchise agreements that had different provisions regarding the advertising fund;

2. Meineke employees had made different oral representations to franchisees regarding the advertising fund;

3. The reliance element of fraud and misrepresentation torts were difficult to prove class-wide;

4. Each franchisee had a different statute of limitations; and

5. Each franchisee had a different claim for lost profits.[113]

While the court stated that it "respect[ed] the fact that class actions may play some role in franchisee-franchisor relations," newer franchise agreements may foreclose that option.[114]

If an independent franchisee association decides to pursue its own claim on behalf of its members regarding the advertising fund, it must overcome the threshold jurisdictional requirement of standing under Article III of the Constitution. As such, the U.S. Supreme Court has held that an association has standing to bring suit on behalf of its members when:

1. its members would otherwise have standing to sue in their own right;

2. the interests at stake are germane to the organization's purpose; and

3. neither the claim asserted nor the relief requested requires the participation of individual members in the lawsuit.[115]

Franchisee associations litigating on behalf of their members that have been dismissed on the pleadings have generally failed to meet the third prong of associational standing. In the franchise context, it is generally advisable that the franchise association seek declaratory relief

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[112] AT&T Mobility LLC v. Concepcion, 563 U.S. 333 (2011).

[113] *Broussard,* 155 F.3d at 340–44.

[114] *Id.* at 345 (citing Remus v. Amoco Oil Co., 794 F.2d 1238 (7th Cir. 1986) (considering whether change in franchisor's policies constituted breach of contract with franchisees or violation of state fair dealership law)); *see* Collins v. International Dairy Queen, Inc., 168 F.R.D. 668 (M.D. Ga. 1996) (five classes certified, including one consisting of all members of the Dairy Queen Operators' Association).

[115] Friends of Earth, Inc. v. Laidlaw Envtl. Servs. (TOC), Inc., 528 U.S. 167, 181 (2003).

only, limit its claims to pure questions of law (*i.e.*, interpretation of the franchise agreement without reference to course of dealing or individual franchisees' circumstances), ensure that the franchise agreements used by the system contain identical or substantially similar language with respect to the specific issues in the case, and be able to demonstrate to the court that the case can be proved based on the use of expert testimony and franchisor documents and witnesses.[116]

With respect to advertising funds specifically, in *DDFA of South Florida, Inc. v. Dunkin' Donuts, Inc.*, a franchisee association alleged that Dunkin' had intimidated a majority of its members to vote in favor of increasing advertising fund fees and implemented a flawed evaluation system for its franchisees.[117] Although the association sought declaratory relief and an accounting of the advertising fund, the federal district court held that the allegations of tortious conduct and breach of contract required individual determinations as to whether Dunkin' committed those torts and whether association's members or Dunkin' Donuts itself complied with the franchise agreement. As such, association's complaint did not raise a pure question of law that could be decided without the participation of its members and the court granted Dunkin's motion to dismiss.[118]

VIII. CONCLUSION

Open and honest collaboration between the franchisors and its franchisees regarding how monies for marketing are collected and spent is not only a good business practice, but it sets reasonable expectations and reduces legal liability for all involved. We conclude with an important lesson learned from a case involving the Sizzler system. When the restaurant franchisor proposed a shift in marketing emphasis away from the buffet court to the grill, it engaged the National Sizzler Franchisee Association ("NFSA") to review, assess, and approve the shift. The marketing committee of the NFSA board of trustees went so far as to make a written finding supporting the franchisor's proposal. When a single franchisee later claimed in Sizzler's bankruptcy that the change violated the implied covenant of good faith and fair dealing, it was dismissed in no small part because of the prior collaborative steps taken by the franchisor.[119] Collaboration on franchisor-generated marketing initiatives that franchisees pay for through fees increases the likelihood of franchisee buy-in. It also reduces overall friction in the system and may very well inoculate a franchisor from claims by disgruntled franchisees.

[116] *See* EA Indep. Franchisee Ass'n, Inc. v. Edible Arrangements Int'l, Inc., No. 3:10–cv–1489 (WWE), 2011 WL 2938077 (D. Conn. July 19, 2011); National Franchisee Ass'n v. Burger King Corp., 715 F. Supp. 2d 1232 (S.D. Fla. 2010); Dunkin' Donuts Franchised Rests. LLC v. Shirjee Invs., Inc., Nos. 08-12836, 08-14213, 2008 WL 5384077 (E.D. Mich. Dec. 23, 2008).

[117] DDFA of S. Fla., Inc. v. Dunkin' Donuts, Inc., No. 00-7455-CIV, 2002 WL 1187207 (S.D. Fla. May 22, 2002).

[118] *Id.* at *7.

[119] In re Sizzler Int'l, 225 B.R. 466, 471–72 (Bankr. C.D. Cal. 1988).

BIOGRAPHIES

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Thomas Ayres is an associate at Witmer, Karp, Warner & Ryan LLP and, together with Eric Karp, form the firm's Franchise Practice Group. He has a wide-ranging franchise and business litigation practice representing franchisees, dealers, distributors, and area/regional developers in various dispute resolution forums. He also has advised and represented several independent franchisee associations.

Prior to joining Mr. Karp, Mr. Ayres worked in the Boston office of a large firm litigating complex civil matters. He also counseled individual and corporate clients involved in investigations by state and federal regulators and prosecutors. Fluent in Spanish, he also represented Latin American countries and multinational corporations before U.S. federal courts and international arbitral tribunals.

Mr. Ayres is a graduate of Hamilton College (B.A. summa cum laude, 1998) where he majored in Spanish and Comparative Literature. He received his law degree from Boston College Law School (J.D., 2004), where he served as Senior Managing Editor of the International and Comparative Law Review. After graduation, he served as a law clerk for the Honorable Scott J. Kafker at the Massachusetts Appeals Court, working on a variety of civil and criminal matters.

BEATA KRAKUS

Beata Krakus is a partner of Greensfelder, Hemker & Gale, P.C., and part of the firm's Franchising & Distribution Practice Group. She works with franchisor clients in domestic and international franchise transactional matters, as well as related areas such as distribution and sales representative arrangements, and other commercial contracts. She has advised, structured, and prepared franchise programs for many different franchise concepts including real estate brokerages, hotels, restaurants, and fitness and personal health systems.

Prior to joining Greensfelder, Ms. Krakus was an associate with Sonnenschein Nath & Rosenthal LLP. She also practiced in Warsaw, Poland with the Swedish law firm of Magnusson Wahlin.

Ms. Krakus is a member of the Governing Committee of the ABA Forum on Franchising and also serves as the Marketing Officer for the organization. She has previously served as the organization's Technology Officer and Information Officer. She was an Associate Editor for *The Franchise Lawyer*, has herself written articles for the *Franchise Law Journal* and other franchise law publications, and has spoken repeatedly at the ABA Forum on Franchising and International Franchise Association Legal Symposium. She is recognized by International's Who's Who of Franchise Lawyers and by Chambers USA and Chambers Global.