

**American Bar Association
38th Annual Forum on Franchising**

**DRAFTING AND NEGOTIATING CHALLENGING PROVISIONS
IN FRANCHISE AND DEVELOPMENT AGREEMENTS**

**Elizabeth S. Dillon
Gray Plant Mooty
Minneapolis, MN**

**Leonard D. Vines
Greensfelder, Hemker & Gale, P.C.
St. Louis, MO**

**Susan E. Tegt
Self Esteem Brands, LLC
Minneapolis, MN**

**October 14 – 16, 2015
New Orleans, LA**

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TABLE OF CONTENTS

I.	INTRODUCTION.....	1
II.	SINGLE UNIT FRANCHISE AGREEMENTS.....	2
	A. Territory	2
	1. Determining the Protected Territory	3
	2. Right of First Refusal	4
	3. Franchisor's Sale of Goods within a Protected Territory.....	5
	B. Term of Franchise Agreement.....	5
	1. Initial Term	5
	2. Renewal Term.....	5
	C. Initial Franchise Fees and Royalties.....	7
	D. Transfers/Assignments.....	8
	1. Conditions the Franchisor May Impose Upon Transfer	8
	2. Franchisee Counsel Must Consider the Franchisee's Individual Circumstances	9
	E. Advertising.....	11
	F. Additional Support/Ongoing Training.....	12
	G. Vendors	13
	H. Noncompetition and Confidentiality Clauses	14
	I. Lost Future Royalties.....	15
	J. Liquidated Damages.....	17
	K. Arbitration Clauses	20
	L. Discretionary Terms	20
	M. Personal Guaranties.....	21
	1. Financial Limitations	22

2. Disappearing Guaranties	22
3. Types of Obligations Guaranteed	23
4. Spousal Guaranty Limitations	23
5. Inactive Owner Guaranties	25
6. Related Entity Guaranties	25
III. AREA DEVELOPMENT, AREA REPRESENTATIVE AND MASTER FRANCHISE AGREEMENTS	25
A. Distinction between Different Multi-Unit Agreements	26
1. Area Development Agreements.....	26
2. Area Representative Agreements.....	26
3. Master Franchise Agreements.....	27
B. Territory	27
C. Reservation of Rights	28
D. Development Schedule	29
1. Area Development Agreements.....	30
2. Area Representative Agreements.....	30
3. Master Franchise Agreements.....	31
E. Initial Fees	32
1. Area Development Agreements.....	32
2. Area Representative Agreements.....	33
3. Master Franchise Agreements.....	33
F. Ongoing Fees	33
1. Area Development Agreements.....	33
2. Area Representative Agreements.....	34
3. Master Franchise Agreements.....	35
G. Cross Default.....	35

	H. Rights Upon Expiration or Termination of the Multi-Unit Agreements.....	36
	I. Form of Unit Franchise Agreement under a Master Franchise Agreement	36
IV.	SYSTEM-WIDE NEGOTIATIONS.....	37
V.	FDD DISCLOSURES FOR NEGOTIATED CHANGES	37
	A. Impact of Negotiation on FDD Disclosure	37
	B. Impact of Negotiation on Timing of FDD Disclosure	38
	C. California Negotiated Change	39
	D. California Material Modification of Existing Franchise.....	40
	E. Virginia Requirement to Negotiate	40
VI.	NEGOTIATING TIPS	41
VII.	CONCLUSION	42

DRAFTING AND NEGOTIATING CHALLENGING PROVISIONS IN FRANCHISE AND DEVELOPMENT AGREEMENTS

I. INTRODUCTION¹

Conventional wisdom is that franchise agreements are, at least for the most part, not negotiable. Although that may be particularly true for a single unit franchisee negotiating with a large, well-established franchisor, there are indeed situations in which negotiations are possible. For example, a start-up franchisor anxious to sell franchises is likely to be amenable to granting early franchisees terms that are more favorable than what appears in its standard franchise agreement. However, a franchisor that is too willing to negotiate and make big concessions could signal a franchisor who is only interested in—or worse, desperate for—a large initial franchise fee without regard to the long term impact on uniformity and the importance of selectively granting franchises to qualified prospects.

In some cases, an experienced, financially strong franchisee that already has investments in other franchise or non-franchised businesses, or that is willing to commit to developing a large territory, particularly in an area where the franchisor wants to establish a presence, will be particularly attractive to a franchisor. Under such circumstance, the negotiation playing field may be somewhat leveled. Likewise, a franchisor that sees a prospect as someone who can bring real value or prestige to the system may grant concessions that it would not ordinarily make to a typical franchisee. Although many franchisees who purchase franchises are not represented by an attorney and are under the impression that the franchisor will not negotiate, as franchising has matured many franchisees have become more sophisticated and have ready access to substantial information about the franchise and franchise negotiations (such as through the internet). Furthermore, franchising has become so prevalent that someone looking to buy a franchise now has a myriad of other opportunities to consider. If a franchisee is converting an existing independent business to a franchise, it will bring operating skills and knowledge to the business and may reduce the amount of training and support that would otherwise be required. As a result, the franchisee would be justified in requesting modifications to various requirements, such as the non-compete, initial franchise fees, and even royalties if the franchisee will be bringing business that it had already originated.

Although large, well established, highly sought after franchisors can adopt the “take it or leave it” approach to negotiating, franchisors are not always opposed to making some revisions to their standard form agreements.² Indeed, one noted franchise consultant suggests that the following provisions might be subject to negotiation: (a) additional early and grand-opening support, including franchisor contributions to grand opening advertising and marketing; (b) changes to the time to begin operations; (c) modifications to the size of the protected territory, or if one is not granted a certain area around which the franchisor will not compete; (d) changes to transfer fees; and (e) changes in time to cure defaults.³ Of course, the willingness of franchisors to do so is far from uniform and some may refuse to negotiate at all.

¹ The authors wish to thank Kimberly Myers, an attorney at Greensfelder, Hemker, & Gale, PC, and Bryan Huntington, an attorney at Larkin Hoffman Daly & Lindgren, Ltd. for their contribution to this paper.

² See, Peter C. Lagarias and Edward Kushell, *Fair Franchise Agreements from the Franchisee Perspective*, 33 FRANCHISE L.J. 3 (2013).

³ Michael H. Seid, *Negotiating Franchise Agreements—Are the Terms Fixed in Stone?*, MSA WORLDWIDE 1, 2–3 (2011), <http://www.msaworldwide.com/Negotiating-agreements.pdf>.

In any event, regardless of what provisions are subject to negotiation, the franchise agreement will be more one-sided in favor of the franchisor. Since franchisors must protect their brand and maintain uniformity, many provisions should be off-limits for negotiations, such as those intended to protect the trademarks, the brand, and uniformity and consistency of the system. In addition, there are also advantages and efficiencies to franchisors whose franchisees operate under the same form of agreement.

This paper will focus on those sections of franchise and area development agreements that might pose challenging drafting issues, but which are the types of issues that often arise where the franchisor's bargaining power does not dramatically outweigh the bargaining power of the franchisee. Drafting of certain types of provisions are relatively straightforward and modifications can be accomplished with ease, while others are more intricate and nuanced.

II. SINGLE UNIT FRANCHISE AGREEMENTS

A. Territory

A protected territory is a geographic area in which the franchisor has agreed it will neither operate company-owned stores, nor license other franchisees, selling the same or similar goods or services under the same or similar marks as a franchisee.⁴ The question of whether and to what extent a franchisee will receive a protected territory may be a major point of contention in contract negotiations. A franchisor—and particularly, a large and more successful/established franchisor—may require all franchisees to agree to operate a unit-only franchise (i.e., they have *no* protected territory and therefore no territorial protections) and, further still, may require franchisees' express agreement that the franchisor has the right to compete with them at any place and using any method.⁵

If an established franchisor allows for protected territories, those territories are likely to be limited in scope, typically restricted to a number of miles or kilometers from the franchised location. A franchisor may also reserve the right to establish other units at non-traditional locations with the protected territory, such as airports and military bases, and to use alternate channels of distribution within the territory. The radius of a protected territory is an often-negotiated provision of the franchise agreement, and a franchisee negotiating for a larger protected territory is likely to have better luck negotiating with a newer franchise system that may be more willing to grant a larger protected territory in order to grow the brand.⁶ Similarly, sophisticated franchisees, and franchisees negotiating multi-unit deals, are likely to demand larger protected territories.⁷

⁴ *Amended Franchise Rule FAQ's*, FEDERAL TRADE COMMISSION, Q&A 25, <https://www.ftc.gov/tips-advice/business-center/guidance/amended-franchise-rule-faqs> (last visited June 30, 2015). For the purpose of this paper, the authors have chosen to use the term "protected territory" but are not intending to distinguish that term from an "exclusive territory."

⁵ See Harris Chernow, Kerry Olson & Rebekah Prince, *Is That a Fair Deal? Best Practices for Negotiation of the Franchise Agreement*, A.B.A. F. ON FRANCHISING, 2012, at 6 (noting that established brands may be able to offer less of an exclusive territory).

⁶ See Kevin Adler, *Managing Franchise System Growth from the Start*, 11 FRANCHISING BUS. & L. ALERT, Aug. 2005, at 1, 3 (concluding that young franchisors frequently give away territories that are too large, which may result in problems later on).

⁷ See Lawrence Ashe & Harris Chernow, *Negotiating Franchise Agreements: The Franchisee Perspective*, A.B.A. F. ON FRANCHISING, 2000, at 11.

Both franchisors and franchisees may have principled reasons for taking firm positions on the issue of a protected territory. A franchisor legitimately may have concerns about the impediment that granting protected territories may have on future growth of the system. Rapid population growth in certain areas may mean the franchisee is no longer able to accommodate consumer demand.⁸ In densely populated areas, a franchisor may have an interest in dominating the marketplace by having several franchises in close proximity to each other.⁹ Additionally, a franchisor may be reluctant to negotiate a protected territory if doing so would mean it is acting inconsistent with its franchise disclosure document. Federal regulations require that if a franchisor is going to grant a protected territory, the franchise disclosure document (“FDD”) must specifically so state.¹⁰

On the other hand, territorial exclusivity is viewed as extremely important by most franchisees, and a franchisor’s refusal to grant a protected territory or negotiate for a broader territory may cause distrust between the two parties very early in the relationship.¹¹ Franchises approaching the topic, in addition to requesting broader protected territories and rights of first refusal, should also keep an eye out for contractual provisions allowing the franchisor to reduce the protected territory upon renewal or transfer of the franchise agreement and request such provisions be stricken. Even language requiring the franchisee or transferee to agree to the then-current franchise agreement¹² may be a trap here, as that new agreement may contain a limited protected territory. Similarly, franchisees are advised to carefully review and negotiate any provisions allowing the franchisor to change the protected territory on the basis of demographic or other changes, discussed further below. Such a provision will rarely benefit the franchisee.

1. Determining the Protected Territory

The measure of the geographic area itself is often fuel for any disagreement between franchisor and franchisee. By far the most prevalent way to measure a protected territory is a simple radius covering a number of miles around the franchised location. However, the parties could agree the protected territory is based upon other factors, such as population, households, school districts, proximity to a given landmark, number of cars, etc.¹³ If the franchisor is inclined to grant a protected territory, it should have considered the factual basis behind its proposed protected territory and be prepared to defend why that proposed territory is reasonable. If the franchisor can provide a rational explanation for the protected territory that it is offering, it will

⁸ See Robert Emerson, *Franchise Territories: A Community Standard*, 45 WAKE FOREST L. REV. 779, 785 (2010) (noting how franchisors may decide to franchise new locations because they observe growing populations).

⁹ Chernow, Olson & Prince, *supra* note 5, at 7 (“Franchisors generally want to add a number of franchise outlets in densely populated areas and keep exclusive areas small so that they can dominate the market and outpace their competitors.”).

¹⁰ 16 C.F.R § 436.5(l)(5).

¹¹ Emerson, *supra* note 8, at 779 (recognizing that frequently the franchisee’s expectations are the impetus behind encroachment actions against franchisors).

¹² One or both of the parties, however, may also desire to avoid agreeing to the “then-current” franchise agreement. See *infra* Sec. II.B.2.

¹³ Ashe & Chernow, *supra* note 7, at 11.

likely go a long way towards addressing franchisee concerns about the franchisor running over them roughshod.¹⁴

The parties may agree that a reasonable compromise is that the franchisee will be given a protected territory and that its right to maintain that protected territory is contingent upon it satisfying certain criteria, such as meeting certain sales goals.¹⁵ The franchisor may assert that such an arrangement simply guarantees that the franchisee's territory is being used to its full potential. Having an objective set of criteria govern the size/extent of the franchisee's protected territory gives both parties a modicum of comfort that their interests are being protected.

2. Right of First Refusal

The franchisor may condition its grant of a protected territory on the addition of a provision in the franchise agreement which states that, after the happening of particular events which cause the franchisor to believe the territory warrants an additional franchise location, the franchisor has authority to place another franchisee in the protected territory.¹⁶ A franchisee concerned with this provision may desire to negotiate a right of first refusal in the territory. Thus, if the franchisor decides another franchise should operate in the franchisee's territory, the franchisee will first be given the opportunity to operate a second franchise.¹⁷ The parties may similarly want to negotiate a right of first refusal for adjacent territories. Existing franchisees with strong performance records will be in good positions to negotiate these rights of first refusal, as the franchisor likely has a strong interest in having its top performers acquire additional units. If the parties agree to such an arrangement, it is advisable the franchisor place conditions on the franchisee's ability to exercise the right of first refusal much as the franchisor would place conditions on the franchisee's exercising renewal rights (for instance, the franchisee must not be in material breach of the franchise agreement).

EXAMPLE – Negotiated Right of First Refusal. If Franchisor wants to develop another franchised center within 10 miles of Franchisee's ~~designated territory~~ **Center**, Franchisor will give Franchisee a right of first refusal to acquire that franchised center during the five years following the effective date of this Agreement. To exercise that right of first refusal, Franchisee must sign Franchisor's then-current franchise agreement, must not be in material breach of the franchise agreement, and must pay the initial fee for that franchise, within 20 days after Franchisor sends Franchisee the franchise agreement for that franchised center. If Franchisee does not do so, Franchisee will not have any rights beyond those designated in this Agreement.

Issues regarding the franchisor's demand for a right of first refusal relating to the transfer or assignment of the franchise agreement are discussed in Section II.D.1, below.

¹⁴ Cf. Chernow, Olson & Prince, *supra* note 5, at 7 (stating that a franchisor should have a solid rationale behind its decision not to grant an exclusive territory in order to ameliorate franchisee concerns).

¹⁵ See *Prof'l Shredding of Wisconsin, Inc. v. Proshred Franchising Corp.*, Bus. Franchise Guide (CCH) ¶ 15,423 (S.D.N.Y. Sept. 5, 2013).

¹⁶ Erika Amarante, Andraya Fritz & Karen Satterlee, *Territory, Exclusivity and Encroachment: Thinking Ahead of the Curve and Dealing With The Fallout*, A.B.A. F. on Franchising, 2009, at 4 (suggesting such events could include, among other things, population and demographic changes, or increases in demand for the franchisee's products).

¹⁷ See *id.* (providing an example of sample right of first refusal language).

3. Franchisor's Sale of Goods within a Protected Territory

The franchisor may intend to make sales inside the franchisee's protected territory through alternative means of distribution. This could, for example, include internet distribution or distribution through grocery stores. The best way for a franchisor to accomplish such an objective is to expressly reserve the right to do so in the franchise agreement.¹⁸ For instance, the franchisor may include a provision in the franchise agreement reserving the right to distribute through channels of commerce other than the franchisee's distribution method.¹⁹ Where a franchise agreement contains sweeping language allowing for the franchisor to distribute products within a prospective franchisee's protected territory, the franchisee may want to ask the franchisor to strike this provision altogether, or at a minimum narrowly define only certain distribution methods that will limit a negative impact on the franchisee's sales within the territory.

B. Term of Franchise Agreement

1. Initial Term

The initial term of a franchise agreement is more often than not a product of the particular franchise industry – and, accordingly, is generally non-negotiable.²⁰ Certain franchise industries require significantly higher initial investments than others, and these are likely to have a longer initial term.²¹ In these situations, and others, a franchisee may seek to negotiate a shorter contractual term, perhaps to avoid a liquidated damages provision or to match the term of a franchise agreement with a commercial lease term. Depending upon current economic conditions, franchisees may seek to negotiate a longer initial term on the ground it will take longer to recoup any up-front costs. Similarly, franchisees often press for a longer initial term when necessary to match the length of any agreements secondary to the franchise agreement, such as the lease or financing term.²² During initial negotiations, these demands may be in conflict with the demands of the franchisor who may have an interest in keeping the term of the franchise agreement as short as possible in order to more quickly commit a renewing franchisee to the then-current franchise agreement containing updated system requirements and possibly increased royalty and other fee obligations.

2. Renewal Term

The general rule is that a franchisor has no obligation to offer renewal to a franchisee.²³ When franchisors do offer renewal, they must be cautious about denying renewal to any

¹⁸ See *Newspaper, LLC v. Party City Corp.*, No. 13-1735, 2014 U.S. Dist. LEXIS 89321 (D. Minn. July 1, 2014) (agreeing with franchisor's argument that contractual exception to exclusive territory provision allowed it to make internet sales into the franchisee's exclusive territory).

¹⁹ See *id.*, at *6.

²⁰ See Chernow, Olson & Prince, *supra* note 5, at 14–15.

²¹ See *id.*

²² See Peter Silverman, *Franchisee Considerations in Negotiating Franchise Agreements, Part II*, BLUE MAU MAU (May 26, 2009 11:00 AM), http://www.blumaumau.org/franchisee_considerations_negotiating_franchise_agreements_part_ii.

²³ See Theodore Becker & Michael Boxerman, *Franchise Renewals: Considerations for Franchisors and Franchisees*, 19 FRANCHISE L.J. 45, 64 (1999).

particular franchisee, as in a number of states franchisors may be required to renew by anti-discrimination provisions in relationship statutes unless there is good cause to end the relationship.²⁴ Moreover, a variety of states impose specific renewal obligations on franchisors. California, for instance, permits a franchisor to refuse to renew a franchise *if* the franchisee fails to accept changes to its franchise agreement which would result in renewal on substantially the same terms and conditions on which the franchisor is then customarily granting renewal franchises.²⁵ Minnesota permits a failure to renew without good cause so long as (1) the franchisee is given written notice of the franchisor's intention not to renew at least 180 days before the expiration of the franchise; and (2) the franchisee has been allowed to operate the franchise for a sufficient period of time to enable the franchisee to recover the fair market value of the franchise as a going concern.²⁶ State anti-waiver statutes, where applicable, would likely nullify any agreement that involves the franchisee waiving these rights and thus there may be nothing to negotiate.²⁷

If a franchisor is inclined to offer a renewal term, it has an opportunity to satisfy important objectives. Franchisors frequently attempt to require franchisees to do any of the following: execute a unilateral release of claims related to the franchise; agree to execute the franchisor's then-current franchise agreement; and/or agree to substantially renovate the franchise location.²⁸ The franchisor must be cautious, however, that it does not violate statutory prohibitions. For example, several states prohibit a franchisor from requiring a release.²⁹ A franchisee that knows the pertinent law on renewal is in a solid position to request appropriate changes to the franchise agreement.

Whether and to what extent the franchise agreement must be renewed in the "then-current form" of the franchise agreement is an area that the franchisor and franchisee may both find advantageous to discuss. From the franchisor's perspective, it may be better to avoid the "then-current form" language altogether and instead: (a) explicitly say on what terms the franchisee must renew; or (b) specifically identify the form that must be used. This is because the "then-current form" language may be held to be ambiguous by a court—e.g., it is unclear whether the "then-current form" applies to negotiated changes offered to certain franchisees but not others—which may lead to litigation.³⁰ The franchisee will likely want to secure the continuation of certain material terms that were included in their original franchise agreement, such as the royalty rate and marketing contribution rates. A good compromise may be somewhere in between, perhaps a cap on royalties or other fees that will be greater than the fees imposed by the initial franchise agreement but less than may be imposed by the then-current form to be executed upon renewal. For example, where renewal is conditioned upon the execution of the then-current franchise agreement which may require the payment of ten

²⁴ See *id.*

²⁵ CAL. BUS. & PROF. CODE § 20025(f) (West).

²⁶ MINN. STAT. § 80C.14, subd. 4.

²⁷ See, e.g., MINN. STAT. § 80C.21 (providing, in certain circumstances, that "[a]ny condition, stipulation, or provision" that "waive[s] compliance or which has the effect of waiving compliance with any provision of [the Minnesota Franchise Act] or any rule or order thereunder is void").

²⁸ See, e.g., Becker & Boxerman, *supra* note 23, at 71.

²⁹ *Id.* The particular states are Arkansas, Iowa, Michigan, Nebraska, New Jersey, and Washington.

³⁰ See Joseph Fittante and Dennis Wieczorek, *Advanced Drafting*, A.B.A. F. ON FRANCHISING, 2004, at 8.

percent of gross revenues as a royalty, the franchisee may request language such as, “provided, however, that the standard franchise agreement then being used shall be modified to provide that the Monthly Royalty will not exceed seven percent of the Gross Revenues generated in the preceding month by Franchisee’s franchised business.” Also, there can be ambiguity as to what constitutes the “then-current form” when the franchisor is not then offering new franchises. Using the phrase “most recently used form” removes that ambiguity, although drafters should identify any provisions that apply only to that particular agreement and are not meant to be used as part of a customarily-used or most recently used form.

Another likely sticking point is whether the franchisor will be allowed to charge a renewal fee. The franchisor perspective on renewal fees is that the franchisor will incur expenses in connection with the renewal and the franchisee is benefitting from the increased value of the franchise by renewing and that therefore a renewal fee is appropriate.³¹ The franchisee perspective is likely that the franchisor has already been fairly compensated through payment of the initial franchisee fee and ongoing royalties and consequently no such fee should be imposed just for “business as usual” to continue.³²

Franchisors have good reasons for requiring franchisees to sign the “then-current form” on renewal or transfer; however, large area developers may have more bargaining leverage to retain the negotiated terms that the franchisor agrees to for the first unit. Alternatively, certain provisions, including any provisions negotiated along with the initial franchise agreement, can be “carved out” as remaining even if the general renewal form is used for renewal, transfer, or additional franchises under a development agreement.

C. Initial Franchise Fees and Royalties

The initial franchise fee and ongoing royalty fees are the lifeblood of the franchise system. Is it possible that something so crucial to the franchisor could be negotiable? The perhaps surprising answer is “yes.” However, this is a rare occurrence and it may depend upon a multitude of factors, such as the attractiveness of having that particular franchisee join the system, the franchisee’s background (if any) in franchising and how successful they were/have been, the attractiveness of the anticipated franchise location, and the franchisor’s needs at the time.³³ A franchisee may have particular success negotiating a refund of part or all of the initial franchisee fee in the event certain contingencies occur, including if the franchisee is unable to complete initial training, if no appropriate location for the franchise is found, or if the franchisor has a fair number of units sold but not open at the time of the negotiation.³⁴ Further, a franchisee may want to request the franchisor agree to reduce the initial franchise fee or reduce the royalties to be paid to the franchisor during the first few months or years of the operation of the franchise to allow the franchisee more time to strengthen its finances and operations, a result that may also prove beneficial to the franchisor in the long run.

³¹ Cf. Phyllis Truby & David Beyer, *Fundamentals 201: Transfers and Assignments in Franchising*, A.B.A. F. ON FRANCHISING, 2014, at 36 (explaining that franchisors justify the imposition of transfer fees, in part, on the basis that the transferee franchisee is benefitting from the growth in the value of the franchise system and that the franchisor, by imposing a fee, is only realizing this growth).

³² See Chernow, Olson & Prince, *supra* note 5, at 16.

³³ See Ashe & Chernow, *supra* note 7, at 12 (concluding that the initial franchise fee is “not typically negotiated, unless a startup situation or one in which the franchisor is desperate for a franchisee in a particular area”).

³⁴ See Chernow, Olson & Prince, *supra* note 5, at 14.

D. Transfers/Assignments

The franchisor's right to impose restrictions on the franchisee's ability to transfer the franchise agreement can be a controversial issue in negotiations. The franchisor justifiably seeks assurances that any transferee franchisee would qualify under the franchisor's standards, financial or otherwise, that would be imposed upon any new franchisee. The franchisee likely recognizes that transfer of the franchise agreement is the only way it can liquidate the investment if need be.³⁵ The franchisee and franchisor negotiating over transfer and assignment issues may not be doing so on a clean slate: numerous statutes place restrictions on the franchisor's ability to intervene in a transfer situation.

Ten states have laws that restrict a franchisor's right to approve or disapprove a transfer request.³⁶ The franchisor may be required to act reasonably or in good faith, or to have a legitimate business reason for withholding consent to transfer.³⁷ The franchisor may be required to submit its reason for not consenting to the transfer in writing.³⁸ The simple point is that this is another area where state statutes may provide default rules that may not be contracted around by the parties.

1. Conditions the Franchisor May Impose Upon Transfer

Certain states expressly allow the common franchisor practice of imposing conditions on transfer.³⁹ Conditions the franchisor may require on transfer include, among other things: requiring the original franchisee to execute a release; having the transferee franchisee execute the then-current form of franchise agreement; having the transferee franchisee pay a fee; and, that the franchisor has a right of first refusal to purchase the franchise.⁴⁰ A franchisor may also want to approve the sale price as a condition of transfer. Further, a franchisor may seek to include language prohibiting the release of the initial guarantor upon transfer. The initial franchisee may want to attempt to negotiate these provisions before it signs a franchise agreement, as they may later prove to be burdensome. For example, if the franchisor rejects the transfer on the basis that it believes the sale price of the franchise is excessive, perhaps setting the purchaser up for failure, the rejected purchaser may not have standing to sue the franchisor for its actions since it is not a party to the franchise agreement. A franchisee may want to request the franchisor strike such a provision to allow the franchisee greater flexibility at the time of sale.

³⁵ *Id.* at 24.

³⁶ See Truby & Beyer, *supra* note 31, at 6. Those states include Arkansas, California, Hawaii, Indiana, Iowa, Michigan, Minnesota, Nebraska, New Jersey, and Washington. *Id.* at 6 n.39.

³⁷ Compare MINN. STAT. § 80C.14(5) ("It is unfair and inequitable for a person to unreasonably withhold consent to an assignment, transfer, or sale of the franchise whenever the franchisee to be substituted meets the present qualifications and standards required of the franchisees of the particular franchisor."), with MICH. COMP. LAWS § 445.1527(g) (declaring void and unenforceable a franchise agreement provision allowing the franchisor to refuse to permit a transfer of ownership of the franchise except for "good cause," and providing a non-exclusive list of items that may constitute good cause).

³⁸ See ARK. CODE ANN. § 4-72-205(b)(1).

³⁹ See, e.g., *id.* at (c).

⁴⁰ See generally Claudia Levitas & Allan Hillman, *Hot Topics on Transfer and Assignment by Franchisees*, A.B.A. F. ON FRANCHISING, 2005.

EXAMPLE – Negotiated Transfer Provision. Franchisor will not withhold, delay or condition its consent to a transfer, subject to all of the following conditions being satisfied:

* * *

Franchisor is satisfied that the proposed transferee (and if the proposed transferee is an entity, all holders of any interest in such entity) meets all of the requirements for its new franchisees, including, but not limited to, good reputation and character, business experience, and financial strength, credit rating and liquidity, ~~and that the sale price is not excessive;~~

Other franchisor requirements may also impose difficulties on a franchisee seeking to sell its franchise and should be addressed before the franchise relationship is formed. For example, if a franchisor will not agree to strike its right of first refusal upon a transfer of the franchise agreement, the franchisee should, at a minimum, seek to limit the time in which the franchisor may exercise this right. If the franchisor insists on requiring the “then-current form” of the franchise agreement at transfer, making the franchise less marketable to a prospective buyer due to the likelihood of increased royalties or other fees, the franchisee may want to consider negotiating the terms of the future “then-current” franchise agreement with the initial agreement, including putting a cap on royalties and other fees.⁴¹

It is noteworthy that if the initial franchisee declines to negotiate the form of franchise agreement that will apply upon transfer, or negotiates terms that are not acceptable to the proposed transferee, the prospective transferee may be in a position to negotiate more favorable terms. Depending upon the circumstances leading to the transfer, the proposed transferee may have significant leverage if it is in the position to help save a failing franchise or to prevent a location closure.

Last, a franchisee is likely to have a tough time negotiating the amount of any transfer fee, but should nonetheless consider the circumstances leading to the transfer. If the franchisor has a strong interest in transferring the franchise too, perhaps because the franchised location is struggling or likely to close, which may damage the franchisor’s goodwill in the market, the franchisor may be willing to negotiate a reduction in the transfer fee. On the other side of the coin, facilitating a transfer may take significant time and expense for the franchisor between time spent reviewing the prospect’s qualifications, reviewing the terms of the deal, preparing consent documents and, after the transfer, providing training to, and supervision of, the new operator, leading the franchisor to be hesitant to agree to a reduced transfer fee.⁴²

2. Franchisee Counsel Must Consider the Franchisee’s Individual Circumstances

Franchisee counsel should address with the franchisee any unique issues that may arise based upon the franchisee’s anticipated method of operating the franchise. Franchisees should also consider at the time of negotiation what would happen to their franchise upon the occurrence of life events, such as divorce, incapacity, or death, for example. Upon the death of

⁴¹ See Chernow, Olson & Prince, *supra* note 5, at 25.

⁴² See Truby & Beyer, *supra* note 31, at 35.

the franchisee, does the franchise agreement require the franchisee's estate to pay a transfer fee if the franchise is to be transferred to the franchisees' qualified heirs? What if the heirs or personal representatives would prefer to sell the franchise? Below is a sample provision a franchisee may request to mitigate such a dilemma:

EXAMPLE – Transfer Upon Death or Incapacity. If a transfer or assignment is caused by Franchisee's death or incapacity (including the death or incapacity of any person directly or indirectly owning fifty percent (50%) or more of an interest in the entity that is the franchisee under this Agreement), the conditions for transfer or assignment identified in this section must be met by the heir or personal representative succeeding to Franchisee's interest; provided, however, if the heir or personal representative assigns, transfers, or sells its interest in the franchise within one hundred twenty (120) days after Franchisee's death or incapacity, the transferee, and not the heir or personal representative, must comply with the provisions of this section.

Further, if the franchisee intends to transfer the franchise to a trust, either during the franchisee's lifetime or upon the death of the franchisee, franchisee counsel is well advised to work with the franchisor to ensure the succession plan will conform to the franchisor's requirements for approval of the transfer. A franchisor may want to review the terms of any trust documents, likely to ensure, among other things, that there will be sufficient assets in the trust to satisfy the franchisor's standards and that an experienced operator will continue to run the franchise. This rationale applies if a franchisee plans to transfer the franchise to a trust during the franchisee's lifetime or if the transfer is to occur upon the death of the franchisee. Importantly, if a trust or other estate planning document bequeaths the franchise to an unqualified beneficiary, it benefits both parties to work toward a resolution of this issue early in the relationship, rather than face a rejection of the transfer upon the death of the original. As further estate planning considerations, a franchisee may seek agreement that if the franchise is transferred to a trust upon death, no new franchise fee will be required.⁴³ A franchisor may seek to obtain a continuing guaranty from the trust that will not be released upon transfer to a beneficiary.

What about when a franchisee entity seeks to change its internal ownership or transfer a minority ownership interest to a handful of employees? Under the terms of the proposed franchise agreement, will such acts be considered a "transfer" or "assignment" and be subject to the franchisor's approval and a transfer fee? These situations should also be considered at the outset of the franchise relationship, and franchisees are advised to seek terms that place limits on the franchisor's definition of a "transfer" or "assignment," particularly if the transfer will involve only a minority of the franchisee's ownership interest.

Business and marital divorces are other situations that should be contemplated at the outset of the franchise relationship. For example, a franchisor may desire to include a provision making the involuntary or voluntary commencement of business dissolution or buy-out proceedings to be a default under the terms of the franchise agreement. Another option may be for the franchisor to reserve the right of first refusal in the event of a business divorce, perhaps preventing a court from placing the business in the hands of a receiver or a franchisee who would have otherwise not been approved by the franchisor. Another situation ripe for conflict is where the franchise is being run by a married couple that subsequently divorces during the

⁴³ *Id.* at 36.

franchise term. What if the former spouse that receives the franchise in the dissolution proceedings does not meet the franchisor's standards? Would the former spouse who did not receive the franchise continue to be on the hook pursuant to any guaranty? These are issues that should be addressed before executing any franchise agreement.

E. Advertising

Advertising can be an extremely contentious issue during contract negotiations because advertising fees take the form of an out-of-pocket expense for the franchisee. Franchisors and franchisees may have very different goals for advertising: a franchisor likely wants the unfettered right to spend advertising funds as it deems appropriate to build brand loyalty and awareness; a franchisee likely cares only that advertising dollars win customers for *its* franchise location.⁴⁴ To be sure, a successful, established franchisor may tell a prospective franchisee the manner in which advertising fees are collected and/or spent is on a take it or leave it basis. After all, the franchisor's advertisements may have attracted the prospect to the franchise opportunity in the first place.

With respect to national advertising funds, franchisor counsel should be prepared to explain to the franchisee how a larger, national campaign may benefit the individual franchisee (e.g., a national campaign helps build a coherent message about the franchise, which in turn builds greater national brand recognition, which benefits all franchisees in the system). Franchisor counsel should also be prepared to explain why it is necessary for some of the franchisee's advertising dollars to go towards attracting new franchisees to the business. If the brand is new, a franchisee may have greater leverage negotiating national advertising contributions, perhaps by requesting the contribution to the national fund be phased in over a period of time, with initial contributions being spent locally to provide a more visible, at least from the franchisee's perspective, benefit.⁴⁵ However, it is the authors' experience that most franchisors will not negotiate national ad fund contributions for many reasons, including avoiding claims of discrimination and the administrative burden of managing differing ad fund contributions.

Franchisees may have more leverage negotiating local advertising fee contributions. For example, if a franchise agreement contains a requirement that a certain number of dollars must be contributed to the franchisor's local advertising fund, perhaps the franchisee will want to negotiate that it be allowed to spend those dollars itself. Like many negotiated provisions in the franchise agreement, such an accommodation may impose an administrative burden on the franchisor that the franchisor may or may not be willing to live with. Again, the size of the franchise system and the sophistication of the negotiating franchisee may play a key role here. Large area developers, for example, will want to demand that a portion of their advertising fees be used in their local market, particularly if the developer is developing in a market where the franchisor is not currently operating.

Last, a franchisee also may want to request a regular accounting of the fund so that they can ensure advertising dollars are actually being expended, and that they are being expended with at least rough proportionality.⁴⁶ Absent such an accounting obligation it may be impossible

⁴⁴ See Ashe & Chernow, *supra* note 7, at 12 (explaining that franchisees do not want advertising funds to be used in places other than where the franchisee has a location).

⁴⁵ See Chernow, Olson & Prince, *supra* note 5, at 25.

⁴⁶ *Id.* at 23.

to verify that the franchisor is acting appropriately. In the negotiation phase, franchisee counsel should inquire how advertising funds are audited and, if possible, seek to incorporate such requirements in the franchise agreement. Another solution may be to ensure that a committee or franchise advisory council is in place with the ability to influence advertising decisions, including how certain advertising revenues should be spent. Such an arrangement guarantees franchisee input on advertising decisions. It may be wise for franchisor counsel to agree to such an arrangement—doing so helps the franchisor disclaim responsibility for advertising decisions.⁴⁷

F. Additional Support/Ongoing Training

Most franchise agreements will provide for some sort of initial training for the franchisee. This training will take place prior to the opening of the franchise and will often occur at a location convenient for the franchisor, with the franchisee paying for all related expenses (including room and board during the period of training and wages for employees participating in training). The franchise agreement may also provide for some sort of ongoing training for the franchisee. The franchisor may want any additional training to be at its discretion and may want any such contractual obligation to be imprecise as to what is actually required of the franchisor.⁴⁸ The franchise agreement may contain penalties for failures to attend training, penalties that may be negotiable at the time of contracting. Further, if the franchise agreement refers to a policy or operations manual for additional required training, franchisee counsel should ask to be provided with such information.⁴⁹ Franchisee counsel may want to negotiate that any additional required training will be provided at the franchisee's location.⁵⁰

If the franchise agreement is going to provide for specific ongoing obligations for the franchisor, it is advisable for the franchisor to require that the franchisee timely raise any complaints about deficiencies in ongoing training. Perhaps unsurprisingly, in most instances complaints about inadequate or insufficient training arise long after the time the training was to be provided.⁵¹ For various reasons, it can be difficult for the franchisor to disprove claims of inadequate training after the passage of a significant amount of time.⁵² Therefore, the franchisor may be well-served by demanding a contractual provision requiring the franchisee to raise complaints related to training within 30 or 60 days, after which time it is conclusively presumed that the training was sufficient.⁵³ On the other hand, a franchisee will want to request to strike such a provision, similar to the example below, to ensure any claims or counterclaims relating to the franchisor's lack of support are not barred by the terms of the franchise agreement.

⁴⁷ See 1 FRANCHISE & DISTRIB. L. & PRAC. § 3:25 ("Today, many franchisors avoid many of the risks of advertising funds by ensuring that franchisees participate in administering the fund, usually through an advertising council[.]").

⁴⁸ Chernow, Olson & Prince, *supra* note 5, at 17.

⁴⁹ *Id.* at 18.

⁵⁰ See Ashe & Chernow, *supra* note 7, at 12.

⁵¹ Fittante & Wieczorek, *supra* note 30, at 10.

⁵² *Id.* at 11.

⁵³ *Id.*

EXAMPLE – Training. Franchisee agrees that Franchisor is not obligated to provide any training or assistance to Franchisee’s particular level of satisfaction, but as a function of Franchisor’s experience, knowledge and judgment. If Franchisee believes Franchisor has failed to adequately provide any training, Franchisee must notify Franchisor in writing within thirty (30) days following the provided training or Franchisee will be deemed to conclusively acknowledge that all training services provided by Franchisor were sufficient and satisfactory in Franchisee’s judgment, and complied with all representations made to Franchisee.

G. Vendors

It is commonplace for a franchisor to require its franchisees to purchase designated products and services from specific suppliers.⁵⁴ A franchisor may do this to ensure uniformity of the product and to ensure its standards are complied with. These justifications have been upheld by the courts in permitting such requirements.⁵⁵ Nevertheless, it is a frequent complaint of franchisees that they could obtain the same product that they are forced to purchase from a particular supplier at a lower price on the market. At the time of negotiation of the franchise agreement, franchisee counsel may wish to secure a contractual provision providing a mechanism for the franchisee to purchase its products from alternate suppliers.⁵⁶ For example, where a franchise agreement requires franchisees to purchase only pre-approved products, the franchisee may want to ensure that this restriction is placed only on the type of product and not on the distribution channels for that product, leaving the franchisee the option to find a more cost-efficient wholesaler or distributor. In the event the franchisor agrees to these terms, the franchisor will want to include a provision requiring its prior approval for the use of any supplier or distributor outside of its network and will want the ability to revoke the provision for any reason whatsoever. In contract, the franchisee may seek to limit such authority.

EXAMPLE – Designated Supplier. Franchisee will purchase only such types or brands of inventory, products and supplies that Franchisor approves as meeting Franchisor’s quality standards. Franchisee acknowledges and agrees that certain products or supplies Franchisee may be required to purchase for use in the operation of its franchise must be purchased from designated suppliers or vendors (the “Designated Vendor Network”); provided, however, that Franchisee may purchase those products and supplies from a supplier or distributor outside of Franchisor’s Designated Vendor Network so long as Franchisee obtains the prior written approval of Franchisor. Franchisor may at any time withdraw its approval for any reason whatsoever in the event the distributor or supplier causes, or is likely to cause, damage, in the Franchisor’s sole discretion, to the Franchisor’s goodwill or franchise system.

⁵⁴ See, e.g., *Massey, Inc. v. Moe’s Southwest Grill, LLC*, No. 1:07-CV-0741, 2015 U.S. Dist. LEXIS 12281 (S.D. Ga. Feb. 3, 2015).

⁵⁵ See *Queen City Pizza, Inc. v. Domino’s Pizza, Inc.*, 124 F.3d 430, 440–41 (3d Cir. 1997) (recognizing that franchise tying arrangements help prevent franchisee “freeriding,” that is, “offering products of sub-standard quality insufficient to maintain the reputational value of the franchise product while benefitting from the quality control efforts of other actors in the franchise system”).

⁵⁶ Chernow, Olson & Prince, *supra* note 5, at 20.

The franchisor may have good reason to be reluctant to negotiate on supply issues. For instance, the franchisor may have secured a rebate of monies paid to the supplier.⁵⁷ At the time of negotiations franchisor counsel should be well-versed in any collateral benefits that the franchisor has secured through its current supply arrangements. Realistically, a franchisor that has negotiated arrangements with particular suppliers is not likely to agree to any contractual provision that would result in a situation where franchisees are using products coming from a handful of suppliers. Such an arrangement is directly contrary to the notion that all franchises should be uniform in quality and appearance.

H. Noncompetition and Confidentiality Clauses

From the franchisor's perspective, the non-competition provision may be one of the most important provisions in the franchise agreement.⁵⁸ These provisions protect the know-how taught to the franchisee and keep them from one day—after they have learned everything the franchisor has to teach—going into active competition with the franchisor. The franchisor's advanced knowledge of how to operate a successful business likely inspired the franchisee to go into franchising in the first place.⁵⁹ Given this state of affairs, the probability that the franchisee is going to persuade the franchisor to loosen its non-competition provision or confidentiality requirements is slim at best. For franchisors that operate in only a few states, the incentive to negotiate over non-competition provisions may be minimized further still if courts in those jurisdictions are willing to revise and enforce overbroad non-competition provisions to the extent the courts deem reasonable.⁶⁰ As with other franchise agreement provisions, state statutes may take the issue out of the control of the parties by defining the maximum extent to which non-competition provisions may be enforceable,⁶¹ or by even declaring them *per se* invalid.⁶²

Prospective franchisees with previous industry experience, including those seeking to convert their existing business into a franchised business, may have greater leverage when negotiating the scope of a restrictive covenant. A franchisor should consider that it may have a difficult time enforcing its traditional noncompete on a franchisee that learned much of the business elsewhere, thereby lessening the argument that the traditional noncompete protects its legitimate business interests. Passive investors and minority owners may also seek to negotiate the scope of the noncompete, and the franchisor should acknowledge that such restrictions may not apply to those individuals anyway. A sample carve-out to a traditional noncompete for a passive investor is below.

⁵⁷ See, e.g., *Martino v. McDonald's Sys., Inc.*, 625 F. Supp. 356, 362 (N.D. Ill. 1985) (for a period of time Coca-Cola—the supplier selected by McDonald's for soft drinks—paid an allowance into McDonald's national advertising fund).

⁵⁸ See Fittante & Wieczorek, *supra* note 30, at 13.

⁵⁹ Derek Ronde & James Susag, *What do you Mean I Have to Enforce This Provision!?! The Six Most Important Provisions to Run By a Litigator Before Finalizing Your Franchise Agreement*, INT'L FRANCHISE ASS'N 1, 2 (2015) ("a franchisee buys the right to use the franchisor's proven formulae for economic success").

⁶⁰ See *Mister Softee, Inc. v. Tsirkos*, Bus. Franchise Guide (CCH) ¶ 15,296, at 9 (S.D.N.Y. June 5, 2014) (narrowing reach of non-competition provision deemed to be overbroad).

⁶¹ See FLA. STAT. § 542.335(1)(d)(2) (prescribing presumptions as to the reasonableness of non-competition provisions in the franchise context based upon the period of time for which the non-competition provision remains in effect).

⁶² See CAL. BUS. & PROF. CODE § 16600 (West).

EXAMPLE – Non-Compete Carve Out for Passive Investor. The purchase of a publicly traded security of a corporation, or a passive investment in a private entity, engaged in an competitive business or service will not in itself be deemed to violate the terms of this covenant not to compete so long as the Franchisee (and all guarantors of the franchise agreement) do not own, directly or indirectly, more than five percent (5%) of the securities or equity of such corporation or entity, and the Franchisee and all guarantors of this Agreement are not involved in any manner with the decision-making, operation, or conduct of the business of such corporation or entity.

I. Lost Future Royalties

When granting a franchise, a franchisor wants some degree of certainty that, if it invests the time and resources into the franchisee and opening its outlet, it will receive the royalty stream it expects to receive under the franchise agreement for the full term of that agreement.⁶³ A franchisee wants some comfort that, if the franchised business fails for reasons beyond its control despite its best efforts or if life circumstances change, it can exit the business without suffering further financial devastation by being forced to pay royalties when the business is not generating sufficient revenue or has closed. What happens upon an early termination of the franchise agreement, and whether the franchisor is entitled to prospective damages based upon a breach of contract claim, is a frequently litigated issue and addressing this issue upfront can reduce the uncertainty and risk of expensive litigation down the road.

A franchisor must decide whether to include in its standard form franchise agreement a provision specifically addressing lost future royalties in the event of an early termination of the franchise agreement, or to remain silent on this issue and take its chances in court on a breach of contract claim. If the franchisor leaves out any reference to lost future royalties, the franchisor can still make a claim for damages based upon breach of contract.⁶⁴ The case law regarding lost future royalties is unsettled territory in many states so a franchisor is left with a great deal of uncertainty no matter what it chooses. If a lost future royalties provision is included, the franchisee who has retained knowledgeable franchise counsel will likely try to negotiate the provision.

It is unclear in many states whether the franchisor can recover lost future royalties if the franchisor terminates the franchise agreement, even if the franchisor terminates as a result of the franchisee's repeated breach of the agreement. The seminal case on this issue is *Postal Instant Press, Inc. v. Sealy*, 43 Cal. App. 4th 1704 (Cal. Ct. App. 1996), in which the appellate court overruled the lower court and ruled against lost future royalties. In denying lost future royalties, the Court held that the franchisor's decision to terminate the franchise agreement was the "proximate cause" of the loss of future royalties and not the franchisee's failure to pay past

⁶³ For a more in-depth discussion of lost future royalties, see Douglas R. Hafer & Logan W. Simmons, *Lost Future Royalties: Lessons from Recent Decisions*, 31 FRANCHISE L. J. 150 (2012); see also BYRON E. FOX & BRUCE S. SCHAEFFER, *Royalties*, in FRANCHISE REGULATION AND DAMAGES ¶ 8.02 (Wolters Kluwer 2015); Robert Einhorn, *Burger King Corporation v. Hinton, Inc.: Are Lost Future Profits Disappearing?*, 22 FRANCHISE L. J. 159 (2003); Joseph Schumacher & Kimberly S. Toomey, *Recovering Lost Future Royalties in a Franchise Termination Case*, 20 FRANCHISE L. J. 116 (2001); John Jett, *The Once and Future Royalty: Recovery of Lost Future Royalties Upon Termination by Franchisor*, 18 A.B.A FORUM ON FRANCHISING, no. 2, Spring 2015, available at http://www.americanbar.org/publications/franchise_lawyer/2015/spring/royalty.html.

⁶⁴ See *Purosystems, Inc. v. John Woods*, American Arbitration Ass'n, Case No. 32 114 Y 00002 114, Bus. Franchise Guide (CCH) ¶ 15,539 (Nov. 18, 2014) (noting that Florida law did not require an explicit reference in the parties' contract reserving the right to lost future profits).

due amounts. The Court included as a secondary reason for denial of lost future royalties that it would violate statutory and common law prohibitions against damages that are “unreasonable, unconscionable or grossly oppressive.”

Since *Sealy*, courts have generally split on whether to follow the “proximate cause” rationale in *Sealy* or to apply a traditional contract damages analysis where the franchisor is entitled to receive its “benefit of the bargain” under the franchise agreement. Specifically, the Georgia Court of Appeals recently rejected *Sealy* stating that the “*Sealy* decision has been roundly criticized for its abandonment of traditional contract principles,” and concluded that the franchisor was entitled to lost future royalties “that it would have received if [franchisee’s] breach had not prompted [franchisor’s] termination of the franchise agreement prior to the completion of its original 20-year term.”⁶⁵

In addition, some courts have distinguished between cases in which the franchisor terminates the franchise agreement and cases in which the franchisee terminates or abandons the franchised location. In 2003 a California lower court held that *Sealy* did not preclude a claim for lost future royalties as a matter of California law if the franchisee terminates the agreement, or if the franchisor terminates the agreement but the franchisee’s conduct proximately causes the damages, and the award is neither excessive, oppressive nor disproportionate.⁶⁶ The Court in *Radisson Hotels v. Majestic Towers* also strongly disagreed with *Sealy*, and declared that the *Sealy* Court’s holding “that a franchisor has no remedy but to sue the franchisee over and over again as lost royalties accrue,” was simply untenable and unpersuasive.⁶⁷ In *Radisson*, after the franchisee was terminated for failure to pay royalties, the Court allowed the franchisor to recover two times the royalties paid during the prior year pursuant to the liquidated damages clause.⁶⁸ The Court found two years to be appropriate after the franchisor alleged that it took them two years, on average, to find a replacement franchisee.⁶⁹ Despite the lack of a claim in the complaint for lost future royalties, the Court found it necessary to discuss lost future royalties as a means to the final determination of liquidated damages.⁷⁰

So what are the parties to do?

If a franchisee has negotiating leverage, the franchisee may request to add a provision to the franchise agreement specifically stating that it’s not liable for lost future royalties in the event of an early termination of the agreement. The following are sample provisions for consideration:

EXAMPLE – No Lost Future Royalties. In no event will Franchisee be liable for damages, including but not limited to lost future royalties, lost future profits, or

⁶⁵ *Legacy Academy, Inc. v. JLK, Inc.*, 765 S.E.2d 472 (Ga. Ct. App. 2014), *reconsideration denied* (Dec. 15, 2014).

⁶⁶ *It’s Just Lunch Franchise LLC v. BFLA Enterprises, LLC*, No. 03-CV-0561, 2003 WL 21735005 (S.D.Cal. July 21, 2003).

⁶⁷ *Radisson Hotels v. Majestic Towers*, 488 F. Supp.2d 953, 960 (C.D. Cal. 2007); *see also* Fox & SCHAEFFER, *supra* note 62, at 7.

⁶⁸ *Radisson Hotels*, 488 F. Supp.2d, at 960–62.

⁶⁹ *Id.* at 960.

⁷⁰ *Id.* at 962–64.

special or consequential damages, as a result of a termination of this Agreement prior to the expiration of the term or any renewal term for any reason.

EXAMPLE – No Lost Future Royalties if Death, Disability, Retirement. If Franchisee ceases operation of the Franchised Outlet due to retirement, resulting in Franchisee ceasing to provide Services, or upon the death or permanent disability of the Franchisee or its principal owner, this liquidated damages provision will not apply. In the event of retirement, death or permanent disability, Franchisee will not be liable for any future or lost profit damages resulting from the early termination of this Agreement. Franchisee will still be liable for any amounts due Franchisor up to the date of such early termination.

EXAMPLE – No Lost Future Royalties if Insufficient Earnings. If Franchisee has been in business for at least two (2) years and thereafter permanently close Business, because the average earnings before interest, taxes, depreciation and amortization is less than X% of the Adjusted Gross Sales (as defined in the Franchise Agreement) during any six (6) consecutive month period, Franchisee will not be liable for lost future profits.

EXAMPLE – Negotiated Mutual Waiver (Area Developer). ~~Franchisor~~In no event shall ~~neither party~~ be liable ~~to Area Developer~~ for any incidental, consequential, indirect or special losses or damages, (including but not limited to lost profits, ~~interest expense, increased construction or occupancy costs, or other costs and expenses incurred by Developer by reason of~~ lost revenues and loss of business), whether conditioned by any failure to perform or the breach of any representation, warranty, covenant or other obligation (including but not limited to any delay in the delivery of Franchisor's Franchise Disclosure Document ~~caused by legal incapacity during the Term, or any other conduct not due to the gross negligence or gross misfeasance of Company. Except~~ except where the claim (a) is a third party claim subject to indemnification under Section ____ above, or (b) arises out of gross negligence, willful misconduct or fraud. Therefore, except with respect to third party indemnification claims as set forth in Section ____, the parties ~~waive to the fullest extent permitted by law any right to or claim for any punitive or exemplary damages against the other and~~ agree that, in the event of a dispute, the party making the claim will be limited in recovery to equitable relief and any actual damages it sustains.

J. Liquidated Damages

One alternative to the problems associated with proving lost future royalties is to include a liquidated damages provision in the franchise agreement.⁷¹ Since it may be difficult for the franchisor to prove actual damages in the event of an early termination of the franchise agreement, a franchisor may opt to use a pre-determined formula as the measure of damages in lieu of being in a position of having to prove actual damages. Although liquidated damages clauses are most often seen in franchise agreements for hotels (which generally do not include post-term non-competes), since actual damages can often be difficult and costly to prove, they

⁷¹ For a recent review of the law of liquidated damages as it applies in the franchise, dealership, and distributorship context, see Deborah S. Coldwell, Altresha Q. Burchett-Williams & Melissa L. Celeste, *Liquidated Damages*, 29 FRANCHISE L.J. 211 (2010) (which also contains a state by state survey), and Hafer & Simmons, *supra* note 63, at 150. See also *Super 8 Motels, Inc. v. Rahmatullah*, Bus. Franchise Guide (CCH) ¶14,228 (S.D. Ind. Sept. 9, 2009).

are becoming more common in other franchise agreements. “Liquidated damages provisions can be extremely beneficial in helping parties to avoid the difficulty and expense that otherwise might be incurred to prove damages and they are most useful in those situations where the calculation of actual damages would be complex and would require the analysis and opinions of expert witnesses.”⁷²

EXAMPLE – Liquidated Damages Based on Royalties. If this Agreement terminates by action of the Franchisee or under Section 16 [insert section listing events of default that would allow the Franchisor to terminate the agreement], Franchisee shall pay Franchisor within 30 days following the date of such event, as ‘Liquidated Damages’, because actual damages incurred by Franchisor will be difficult or impossible to ascertain, and not as a penalty, an amount equal to the sum of accrued Royalty Fees during the immediately twenty-four (24) full calendar months, plus any applicable taxes assessed on such payment. Payment of Liquidated Damages shall be in addition to Franchisor’s other rights under this Agreement.

EXAMPLE – Liquidated Damages on Termination Based on a Formula. Franchisee acknowledges and agrees that the premature termination of this Agreement will cause substantial damage to Franchisor. Franchisee agrees that Liquidated Damages are not a penalty, but represent a reasonable estimate of the minimum just and fair compensation for the damages Franchisor will suffer as the result of Franchisee’s failure to operate the Hotel for the Term. If this Agreement terminates before the Expiration Date, Franchisee will pay Franchisor Liquidated Damages as follows:

A. If termination occurs before Franchisee begins the Hotel Work, and Franchisee or any Guarantor (or Franchisee’s or any Guarantor’s Affiliates) directly or indirectly, enter into a franchise, license, management, lease and/or other similar agreement for or begin construction or commence operation of a hotel, motel, inn, or similar facility at the Hotel Site under a Competitor Brand within one (1) year after termination, then Franchisee will pay Franchisor Liquidated Damages in an amount equal to \$2,000 multiplied by the number of approved Guest Rooms at the Hotel.

B. If termination occurs after Franchisee begins the Hotel Work but before the Opening Date, Franchisee will pay Franchisor Liquidated Damages in an amount equal to \$2,000 multiplied by the number of approved Guest Rooms at the Hotel, unless Franchisee’s failure to complete the Hotel Work was the result of Force Majeure.

C. If termination occurs after the Opening Date but before the second anniversary of the Opening Date, Franchisee will pay Franchisor Liquidated Damages in an amount equal to \$2,000 multiplied by the number of approved Guest Rooms at the Hotel.

D. If termination occurs after the second anniversary of the Opening Date but before the final five (5) calendar years of the Term, Franchisee will pay

⁷² Michael Tyler, *The Enforceability of Liquidated Damages Clauses in Hotel Franchise Agreements*, L.J. NEWSLETTERS FRANCHISING BUS. & L. ALERT, Aug. 2011.

Franchisor Liquidated Damages in an amount calculated by dividing the sum of the Monthly Royalty Fees due to Franchisor under this Agreement for the prior twenty-four (24) month period by twenty-four (24) and then multiplying the resulting sum by sixty (60).

E. If there are less than sixty (60) months remaining in the Term on the date of termination, Franchisee will pay Franchisor Liquidated Damages in an amount calculated by dividing the sum of the Monthly Royalty Fees due to Franchisor under this Agreement for the prior twenty-four (24) month period by twenty-four (24) and then multiplying the resulting sum by the number of months remaining in the Term.

F. Payment of Liquidated Damages. Payment of Liquidated Damages is due thirty (30) days following termination of this Agreement or on demand.

The enforceability of liquidated damages depends on state law. Although Minnesota and Nebraska do not enforce liquidated damages provisions, they are, with variations, generally enforceable if, at the time that the clause is drafted: (a) it would be difficult to determine potential damages resulting from a breach; (b) the parties agree that the liquidated damages are a fair and reasonable estimate of the damages that the non-breaching party would suffer in the event of a breach; and (c) the damages are not punitive or in the nature of a penalty. When drafting a liquidated damages provision, it is advisable to include specific language evidencing the agreement of the parties to the criteria noted above, along with an acknowledgment that the parties have discussed the methodology and reasoning for determining the amount of liquidated damages and agree that it represents a fair and reasonable estimate of damages resulting from a breach. Liquidated damages should not be overly excessive and may not be altered to correspond to actual damages after the fact.

Liquidated damages should also be adjusted to reflect the fact that the damages resulting from a breach near the end of the term of a franchise will be less than they would be in the early years of the relationship. If the liquidated damages amount covers an excessive time period (i.e., from the date of termination to the scheduled expiration date), such a provision that covers many years could be deemed overreaching and thereby unenforceable as a penalty in certain jurisdictions. Recent cases in several jurisdictions demonstrate that formulas based on actual historical financial data, for reasonable periods of time, are more likely to be enforced. For example, in *Noons v. Holiday Hospitality Franchising, Inc.*,⁷³ the appellate court enforced the liquidated damages agreement between a hotel franchisor and a terminated franchisee. The court applied the following three factors: (1) the injury caused by the breach was difficult or impossible to estimate, (2) the parties intended to provide for damages rather than a penalty, and (3) the stipulated sum was a reasonable estimate of the probable loss. Courts in other jurisdictions have utilized similar factors in enforcing liquidated damages provisions.

Although including a liquidated damages provision in a franchise agreement may offer some degree of certainty in the event of an early termination and properly drafted clauses are often upheld, it does not always ward off disputes or litigation over the provision as evidenced by the significant number of cases challenging such provisions.

⁷³ Bus. Franchise Guide (CCH) ¶ 14,511 (Ga. Ct. App. Sept. 30, 2010). See also Tyler, *supra* note 71 (discussing *Noons*, along with *Laquinta Corp. v. Heartland Props., LLC*, Bus. Franchise Guide (CCH) ¶ 14,376 (6th Cir. Apr. 28, 2010), and *Choice Hotels Int'l, Inc. v. Smith Hotel Props., LLC*, Bus. Franchise Guide (CCH) ¶ 14,610 (E.D.N.C. May 6, 2011)).

K. Arbitration Clauses

Franchisors and their counsel are divided on whether they prefer arbitration or dispute resolution through the traditional judge/jury system.⁷⁴ Generally, in any given franchise system the decision is going to depend on the recommendation of counsel drafting the franchise agreement. Among other things, a recommendation in favor of arbitration may be premised upon a belief that modern American juries are biased in favor of franchisees.⁷⁵ A franchisee will likely not have success persuading a franchisor to go with a judge/jury system if the franchisor has selected arbitration. Whatever the identified dispute resolution mechanism, a franchisee will face an uphill battle in negotiating changes to that provision given the franchisor's desire to maintain a uniform dispute resolution process.

The franchisee may nevertheless seek to negotiate matters such as how many arbitrators will sit on a panel, where the arbitration will take place, and whether or not class arbitration is permitted, all of which should be articulately described in the franchise agreement.⁷⁶ Similarly, if the franchise agreement contains a mandatory mediation requirement, the parties may seek to negotiate the procedural terms of the mediation. Additionally, if the arbitration provision purports only to allow the franchisor the right to seek injunctive relief, franchisees should consider asking for similar rights. Franchisee counsel may point out that courts have refused to enforce arbitration provisions as unconscionable when only the franchisor is contractually granted the right to seek injunctive relief.⁷⁷ Alternatively, franchisee counsel may suggest that arbitration rules be selected that contemplate and allow for injunctive relief (see, e.g., the AAA Commercial Arbitration Rules).⁷⁸ While many details of an arbitration may be negotiated, certain matters may be non-negotiable. For example, Supreme Court precedent limits the ability of parties to contract for a broader standard of review than that provided for by the Federal Arbitration Act.⁷⁹

L. Discretionary Terms

Franchisees should be leery of terms in the franchise agreement allowing the franchisor to act "in its sole discretion," to require the Franchisor's express approval prior to engaging in a certain action, or for the franchisor to take a drastic adverse action in the event of a breach. During contract negotiations, a franchisee may seek to propose new terms, terms that may require the franchisor to act not "in its sole discretion" or with the express "right," but rather under the exercise of "reasonable business judgment" or "in good faith." Similarly, where

⁷⁴ Edward Dunham & Michael Lockerby, *Shall We Arbitrate? The Pros and Cons of Arbitrating Franchise Disputes*, A.B.A. F. ON FRANCHISING, 2005, at 1 (noting that some franchisor counsel swear by arbitration, while others openly loathe it).

⁷⁵ Such a viewpoint is not without factual foundation. See *id.* at 7-8 (examining statistics from the year 2000 reflecting a bias against larger corporations).

⁷⁶ Chernow, Olson & Prince, *supra* note 5, at 32.

⁷⁷ See *Nagrampa v. MailCoups, Inc.*, 469 F.3d 1257, 1286-87 (9th Cir. 2006).

⁷⁸ Rule 37(a) of the AAA Commercial Arbitration Rules states that "[t]he arbitrator may take whatever interim measures he or she deems necessary, including injunctive relief and measures for the protection or conservation of property and disposition of perishable goods."

⁷⁹ See *Hall Street Associates, LLC v. Mattel, Inc.*, 552 U.S. 576, 584-589 (2008) (holding that parties may not validly contract for judicial review of arbitration decision for legal error where FAA applies).

appropriate, the term “material breach” may be substituted for “breach,” and where franchisor approval is required, perhaps that approval should “not be unreasonably withheld.” Should a franchisor refuse to modify these provisions, a franchisee may seek to rely on the implied covenant of good faith and fair dealing to overcome these terms in the event of a dispute. However, most courts have held that the covenant of good faith and fair dealing will not trump express rights identified within the franchise agreement.⁸⁰ Therefore, franchisee counsel should carefully review the franchise agreement for these terms and request reasonable adjustments where appropriate.

M. Personal Guaranties

Nearly all franchisors require individual franchise owners to personally guaranty and assume at least some of the obligations under the franchise agreement; this is a requirement that is rarely waived in its entirety.⁸¹ The guaranty, which often includes a specific agreement to assume and be bound by certain obligations in the franchise agreement, is either contained in a separate stand-alone document or may be imbedded in the franchise agreement itself. Typically, a franchisee sets up a corporate entity in order to obtain limited liability or tax benefits, and such entity has few assets and may be under-capitalized. Thus, the franchisor’s chances of recovering losses or damages as a result of a breach of the franchise agreement from the entity alone may be slim.

Franchise owners generally accept without question a requirement of a personal guaranty by their bank for a loan or by their landlord for a lease. But the obligations being guaranteed are wholly different. The bank, unlike a franchisor, is actually parting with funds that the franchisee will receive. A landlord owes a duty to mitigate its damages, and is often successful in leasing the premises to another tenant. The scope and potential liability under a franchise guaranty, however, may be much larger.

Franchisors argue that it is even more important for the franchise owner to personally guaranty the obligations under the franchise agreement, including financial and performance obligations, such as the duty of confidentiality to protect the franchisor’s trade secrets and non-competition covenants, both during and after the termination or expiration of the franchise agreement. Franchisors argue these provisions do not provide much protection without a personal guaranty from the individual franchise owner, as opposed to the corporate entity.⁸²

Those franchisees with the most to lose (i.e., those with a significant net worth or interests in other businesses, those who are making a significant personal investment, or those buying large territories in hopes of opening multiple units) will be the ones most likely to resist

⁸⁰ See William L. Killion, *Putting Critical Decision Making Where it Belongs: Scouring the Franchise Agreement for the “D” Word*, 24 FRANCHISE L.J. 228, 230 (2005). Nonetheless, fact-finders tend to require a franchisor to act reasonably even when exercising its “sole discretion,” either by applying some form of business judgment rule or leaving the issue up to a jury. *Id.*

⁸¹ For a more in-depth treatment of this subject, see Alison McElroy & Nicole S. Zellweger, *Fundamentals 201, Guaranties and Other Franchisee Owner Undertakings: Negotiation, Drafting, and Enforcement Issues*, A.B.A. F. ON FRANCHISING, 2014, at Tab W13. For a discussion of each of the franchisor and franchisee perspectives on personal guaranties, see Rupert M. Barkoff, *Traditional and Avant-Garde Used of Personal Guarantees in Franchise Relationships*, 23 FRANCHISE L.J. 137 (2004); Charles Modell, *What Do Personal Guarantees Offer?*, 23 FRANCHISE L.J. 138 (2004).

⁸² Emma Cano, Darcy E. Cohen & Diane Green-Kelly., *Unsigned Obligations: When Are Non-Signatories Bound?*, A.B.A. F. ON FRANCHISING, 2013, at Tab W2; Michael R. Gray & Jason M. Murray, *Covenants Not to Compete and Nonsignatories: Enjoining Unfair Conspiracies*, 22 FRANCHISE L.J. 21 (2006).

signing an unlimited monetary personal guaranty, but, absent compelling reasons against doing so, most owners will be willing to agree to be bound by the restrictive covenants in the franchise agreement. Despite the widespread use of personal guaranties, there are options for franchise owners to limit the reach of such personal guaranties.

1. Financial Limitations

The parties may agree to set a maximum dollar cap on the franchise owner's liability. The cap may be a sum certain, which should bear some relationship to the franchisee's potential liability and/or the franchisee's creditworthiness, which may be decreased over time if the corporate franchisee does not default under the franchise agreement for a period of time or as the corporate franchisee's creditworthiness increases. For example, if the franchise owner's maximum liability is set at \$500,000 for a ten-year franchise agreement, the parties may agree that the franchise owner's maximum liability will decrease by one-tenth (or \$50,000) after each year without a default.

Alternatively, the parties may agree to set a formula-based cap on the franchise owner's liability instead of a sum certain, in which case the parties will not know the exact dollar amount of the franchise owner's financial liability when the franchise agreement is executed.

One of the reasons for a guaranty is that the corporate franchisee does not have sufficient assets or capitalization to support the obligations under the franchise agreement. If the corporate franchisee's financial condition improves over time, the need for a guaranty may be diminished. In this case, the parties may agree that the guaranty will terminate if the corporate franchisee hits certain financial benchmarks, such as reaching a certain level of sales, net worth, or EBITDA threshold.

If more than one franchise owner is executing guaranties, they would have joint and several liability, such that they all may be liable for the entire guaranteed obligation. In this case, the parties may negotiate a cap on each co-owner's liability equal to their percentage ownership interest in the corporate franchisee.

EXAMPLE – Monetary Cap on Guaranty. Notwithstanding any provision contained in this Guaranty to the contrary, the maximum aggregate liability of the Guarantor under this Guaranty shall be limited to the sum of (a) \$150,000.00 plus (b) interest on the unpaid balance equal to 6% per annum, plus (c) the aggregate amount of all collection and representation costs and expenses (including, without limitation, reasonable attorneys' fees and expenses) in enforcing this Guaranty.

2. Disappearing Guaranties

Under some circumstances, a guarantor may be willing to limit the time period during which the guaranty remains in effect (i.e., a specific number of years), if the franchisee has complied with the terms of the franchise or area development agreement. A franchisee will want to "sleep at night" and will want the guaranty terminated as to future obligations following a transfer of the franchise agreement.

3. Types of Obligations Guaranteed

The parties may limit the guaranty to certain obligations under the franchise agreement. For example, the franchise owner may be willing to guarantee current and past due royalties but not any lost, future royalties in the event of an early termination of the franchise agreement. (See above for a discussion of lost future royalties.) Or, the parties may agree to exclude all financial obligations, relying upon the financial wherewithal of the corporate franchisee, and include only performance obligations, such as confidentiality and non-compete provisions, under the guaranty, if the franchisee is financially sound.

The parties may also exclude indemnity requirements for third party claims, especially if the franchisee has complied with all of the franchisor's policies and procedures. If indemnity for third party claims is not excluded, the potential personal liability of a franchisee could be huge, and far greater than what the franchisee ever imagined, as in the case of a personal injury or death claim resulting from a food-borne illness at a franchised restaurant.⁸³ The stakes are even higher to the franchisee if the indemnified claim is not fully insured. (As a side note, this points to the importance of franchisees maintaining adequate insurance, and of franchisors requiring evidence that it is named as an additional insured under the franchisees' insurance policies.)

A franchisor will often agree to exclude from the reach of a non-compete a small ownership interest in a publicly traded company. And, if the franchisee is converting its business to a franchise with existing business and knowledge of how to operate it, the franchisee will have a strong justification for eliminating or significantly narrowing the non-compete.

4. Spousal Guaranty Limitations

Unless the franchisee is an entity with substantial assets and multiple owners, a franchisor often requires the franchise owner to guaranty the obligations under the franchise agreement.⁸⁴ Where a franchisor is married and without the availability of personal assets, and would be deemed uncreditworthy, franchisors may advise the guarantor-owner of the need for additional guarantors or collateral. Commonly, a franchisee or prospective franchisee will seek to include his or her spouse as a guarantor to ensure that marital property is available as security. The validity of requiring a spousal guaranty is dependent upon the creditworthiness of the applicant spouse and, depending upon the state, the treatment of assets of a married couple under applicable state law.

For example, in a state where spouses own all property by tenancy by the entireties, the creditors of only one spouse cannot execute on the couple's assets to satisfy a debt. Therefore, in a state where property is held in tenancy by the entireties, the franchisor may not be able to reach marital property if the non-applicant spouse is not a party to the franchise agreement or does not sign a personal guaranty.

In community property states, each spouse is liable for debts incurred by the other during marriage, and the income of either spouse and the assets acquired by that income are community property, owned equally by both spouses. Therefore, a non-applicant, uninvolved

⁸³ Barkoff, *supra* note 81.

⁸⁴ For a more in-depth treatment of spousal guaranties, see Ronald A. Giller & Lisa Garner, *Yours, Mine, Ours, and Theirs: The Role of Spousal Guaranties and Consents in the Franchise Relationship*, 33 FRANCHISE L.J. 71 (2013).

spouse later may claim that he or she owns a part of the franchised business solely by virtue of the marriage.

The franchisor also wants the spouse to be bound by the non-compete and confidentiality requirements of the franchise agreement, especially if the spouse will be involved in the operation of the franchise.

However, a franchise owner may have a legal right, if not a business case, to insist that the franchisor drop its requirement for a spousal guaranty. The Equal Credit Opportunity Act (ECOA)⁸⁵ provides that it is “unlawful for any creditor to discriminate against any applicant, with respect to any aspect of a credit transaction ...” on the basis of being in a number of protected classes, including marital status. The ECOA further prohibits a creditor from requiring the signature of a spouse on any credit instrument if the applicant is otherwise creditworthy.

The federal circuit courts have split on the issue of whether the term “applicant” in ECOA includes loan guarantors.⁸⁶ The Sixth Circuit Court of Appeals found that ECOA’s provisions protect against spousal guaranties of loans (where the applicant spouse is otherwise creditworthy).⁸⁷ The Seventh and Eighth Circuit Courts of Appeal, on the other hand, have found that ECOA’s use of the term “applicant” does not include guarantors of loans.⁸⁸ On March 2, 2015, the United States Supreme Court agreed to hear the Eighth Circuit case to decide this issue, and will hear oral argument during its October 2015 term. The Supreme Court’s decision will determine whether a creditor, such as a franchisor, may require a spousal guaranty where the applicant spouse is creditworthy.

If a guaranty violates ECOA, the franchisor will be unable to enforce it,⁸⁹ and may also be liable for actual and punitive damages, court costs and attorneys’ fees.⁹⁰ Specifically, ECOA claims have been successful against franchisors when the spouses were not joint applicants and no consideration was given to state’s marital property laws.⁹¹ The statute also allows for

⁸⁵ 15 U.S.C. § 1691(a)(1) (2013).

⁸⁶ See *Chen v. Whitney Nat’l Bank*, 65 So.3d 1170, 1172 (Fla. Dist. Ct. App. 2011) (holding that a guarantor falls within the definition of “applicant” under the Equal Credit Opportunity Act (ECOA), 15 U.S.C. § 1691(a)(1)); 12 C.F.R. § 202.2(e)). See also *RL BB Acquisition, LLC v. Bridgemill Commons Dev. Group, LLC*, 754 F.3d 380 (6th Cir. 2014) (“Creditors who violate ECOA or Regulation B may be sued for actual damages, punitive damages, and attorneys’ fees. But only ‘applicants’ have the ability to sue for ECOA violations. The ECOA’s definition of applicant does not explicitly include guarantors. Regulation B, however, contains its own definition of ‘applicant,’ and that definition allows guarantors to sue for violations of the spouse-guarantor rule.”).

⁸⁷ See *RL BB Acquisition*, 754 F.3d at 380 (6th Cir. 2014).

⁸⁸ See *Hawkins v. Cmty. Bank of Raymore*, 761 F.3d 937 (8th Cir. 2014), *cert. granted*, 135 S. Ct. 1492 (2015); *Moran Foods, Inc. v. Mid-Atlantic Mkt. Dev. Co.*, 476 F.3d 436 (7th Cir. 2007).

⁸⁹ See *Chen*, 65 So.3d at 1172; *PNC Bank, N.A. v. Miller*, No. 6:13-CV-208-ORL-36, 2013 WL 2455972 (M.D. Fla. June 6, 2013). See also *Silverman v. Eastrich Multiple Investor Fund, L.P.*, 51 F.3d 28, 33 (3d Cir. 1995) (“If a person was required to sign said Guaranty without any reliance by the lender upon her creditworthiness, solely for the purpose of expediting a loan for her spouse and his business, that Guaranty cannot be enforced against her by the original lender.”).

⁹⁰ See *Anderson v. United Finance Co.*, 666 F.2d 1274, 1278 (9th Cir. 1982) (holding that while 15 U.S.C. § 1691e(b) does not require an award of punitive damages for every violation of the ECOA, punitive damages may be awarded even absent a showing of any actual damages).

⁹¹ Giller & Garner, *supra* note 83, at 90. See also *Nat’l Auto Dealers Exch., L.P. v. Sauber*, No. A-2524-09T1, 2011 WL 4529928 (N.J. Super. Ct. App. Div. Oct. 3, 2011).

class actions to be brought for violations. Of course, if the non-applicant spouse is also an owner, officer or director of the franchisee, or if the franchisee's creditworthiness depends on jointly held assets or assets held in tenancy by the entireties, then these restrictions do not apply.

If a spousal guaranty is eliminated for one of the spouses, the franchisor should consider including a negative covenant whereby the guaranteeing spouse promises not to pledge or hypothecate any assets in the guaranteeing spouse's own name.

5. Inactive Owner Guaranties

A franchisor may seek a guaranty of the franchise agreement from all owners, even inactive investors who truly have no involvement in the business.⁹² In some cases, franchisors may only require guaranties from majority owners, owners with a certain percentage of ownership, or those who are involved in the day-to-day operations of the franchise. Inactive investor owners are often reluctant to guarantee any obligations under the franchise agreement. Since they merely are providing financial backing for the franchise without participating in the business activities, they may see no reason to agree not to engage in a competitive business for example. Depending upon the level of involvement of each individual owner, franchisors may be willing to limit the guaranty to monetary obligations and protection of trade secrets. Indeed, non-competes from inactive, investor owners may be difficult to enforce if the owner did not receive any confidential information or trade secrets. The extent of the guaranty required and which owners will be included depends on the franchise system, their business interests, the strength of the other guarantors, and the respective bargaining power of the parties.

6. Related Entity Guaranties

The franchisor also may require guaranties from related entities of the franchisee in lieu of or in addition to a personal guaranty from the individual franchisee owner.⁹³ Individuals may prefer providing guaranties from related entities if it eliminates the need for an individual personal guaranty. If the franchisor is relying on the credit-worthiness of a parent or affiliated entity in granting the franchise, the franchisor will expect that entity as a guarantor. In other cases, the franchisee may be the parent corporation whose primary assets (besides the franchise itself) are the stock of the subsidiary, which may have greater assets and creditworthiness. Another example is in the case of a multi-unit owner who sets up separate entities for each franchised location, in which case the franchisor may expect that related entity to provide cross-guaranties. The franchise owner may attempt to limit the guaranty to those entities associated with the franchise, or seek to have the guaranty terminate once the franchisee reaches a certain financial threshold. (See Paragraph 1 above).

III. AREA DEVELOPMENT, AREA REPRESENTATIVE AND MASTER FRANCHISE AGREEMENTS

While many of the commonly negotiated provisions discussed above apply to both unit franchise agreements and multi-unit franchise agreements, there are distinct provisions in multi-unit agreements that should be examined by franchisor and franchisee counsel. In addition,

⁹² McElroy and Zellweger, *supra* note 81.

⁹³ *Id.*

franchisors and franchisees are more likely to negotiate multi-unit agreements for several reasons.

First, a multi-unit franchisee is making a larger investment in its business than with a single unit franchise. A multi-unit franchisee that commits significant resources also likely has prior business experience and may even be comparing several franchise brands. Because the franchisee is making a larger investment and may be more sophisticated, a franchisor is often more motivated to get the franchisee into the system and may be willing to negotiate terms that it will be unwilling to negotiate with single unit franchisees.

Second, existing multi-unit franchisees who are acquiring additional units often have more leverage and power in the system to negotiate a specific deal. These multi-unit franchisees are valuable to the franchise system and may be able to leverage their positions within the system to gain concessions that a franchisor would not be willing to grant to other franchisees.

Finally, while all forms of multi-unit agreements are used in the United States (especially area development agreements and area representative agreements), multi-unit agreements are almost always used when U.S. franchisors are offering or selling franchises internationally, especially area development agreements and master franchise agreements. International multi-unit franchisees expect that the agreement will be negotiated and often have greater negotiating power. An international multi-unit franchisee has the advantage of knowing the market, and may be more sophisticated and better capitalized than the franchisor.

A. Distinction between Different Multi-Unit Agreements

Before discussing the unique provisions that may be negotiated in multi-unit agreements, it is important that the types of structures are defined. Below is a brief discussion of each of the three most common types of multi-unit franchise structures: area development agreements, area representative agreements, and master franchise agreements. Any reference to “multi-unit franchises” or “multi-unit agreements” include all three types of multi-unit agreements.

1. Area Development Agreements

Under an area development agreement, a franchisor grants a developer the right to develop a specific number of unit franchises during a specific amount of time.⁹⁴ Generally, the developer will have the right to develop these franchised units within a specific geographic area.⁹⁵ The developer and franchisor will enter into a single unit franchise agreement for the development and operation of each unit, and the development agreement acts as the umbrella agreement governing how and when the developer has the opportunity to enter in those unit franchise agreements.

2. Area Representative Agreements

Under area representative agreements, an area representative is granted the right to provide franchise sales services and franchise support services to unit franchises on behalf of

⁹⁴ N. AM. SEC. ADMR'S ASS'N, MULTI-UNIT COMMENTARY (Sept. 16, 2014).

⁹⁵ *Id.*

the franchisor within a specific territory.⁹⁶ The area representative pays the franchisor an initial fee and the franchisor pays the area representative a percentage of ongoing fees it receives from franchisees in exchange for the services the area representative provides.⁹⁷ In addition, the franchisor may require the area representative to operate a franchised unit. The area representative has no direct contractual relationship with the unit franchisees.

3. Master Franchise Agreements

Under master franchise agreements, a master franchisee is granted the right to subfranchise the development and operation of a certain number of franchised units within a specific geographic area.⁹⁸ The franchisor and the master franchisee are parties to a master franchise agreement under which the master franchisee is granted the subfranchise rights, and the master franchisee and subfranchisee are parties to a subfranchise agreement under which the subfranchisee is granted the right to develop and operate a franchised unit.⁹⁹ The franchisor has no direct contractual relationship with the subfranchisee but may have the right to acquire the franchise agreements upon termination or expiration of the master franchise agreement.

B. Territory

Similar to unit franchise agreements, the territory granted to a multi-unit franchisee and the corresponding reservation of rights are provisions that the parties review closely. As discussed above in Section II(A) of this paper, this can be a difficult balance. A multi-unit franchisee wants protection in a certain geographic area as it invests time and money into developing franchised units, while the franchisor wants to protect its brand and retain flexibility in expanding its franchise system.

Franchisors most often grant a protected territory (as previously discussed in Section II(A) above) to multi-unit franchisors.¹⁰⁰ This is especially true when a franchisor is granting an international multi-unit agreement or when the franchise system is expanding into new markets where the franchisor may not have the brand presence, resources, or knowledge to support the sustained growth of unit franchises in that area. When a franchisor grants a protected territory, a franchisor will not develop other franchised units in the territory during the term of the development period, provided that the multi-unit franchisee is in compliance with the terms of its multi-unit agreement. After the expiration of the development period, a franchisor may develop additional units in the territory. A franchisor generally reserves certain rights in the multi-unit territory including the right to develop at airports, military bases, and other non-traditional sites, and to use other channels of distribution, such as sales through the Internet, as described below.

Some multi-unit agreements (particularly area development agreements) may not grant any territorial protection during the development term. In those cases, a franchisee would not

⁹⁶ *Id.*

⁹⁷ *Id.*

⁹⁸ *Id.*

⁹⁹ N. AM. SEC. ADMR'S ASS'N, *supra* note 92.

¹⁰⁰ Will K. Woods & Sarah Yatchak, *Fundamentals 201: The Art and Science of Drafting Multi-Unit Development Agreements*, A.B.A. F. ON FRANCHISING, 2013, at 10-12.

get territorial protection until it signs a unit franchise agreement. A franchisor may like this approach because the franchisor can grant the multi-unit franchisee a larger territory in which to explore locating unit franchises, and still allow the franchisor the right to develop unit franchises in that same area. A multi-unit franchisee will be wary of this provision because the multi-unit franchisee does not want to be competing against other franchisees in the same area for locations or customers. In addition, a franchisor may need to grant a multi-unit franchisee some protection in a territory in order to attract the best candidates.

A multi-unit franchisee also may try to retain its exclusivity in a certain territory following the expiration of the multi-unit agreement. If the multi-unit franchisee successfully develops a market, it may want to prevent the franchisor from establishing additional unit franchises in that area and saturating the market. A franchisor is unlikely to agree to this continued exclusivity as it may hinder the franchisor's ability to further develop a market. A multi-unit franchisee and the franchisor may, however, find a middle ground by allowing the territorial protection to expire, but granting the multi-unit franchisee a right of first refusal for additional unit franchises in that market for a specific period of time.

In addition to the parties' rights within the territory, the size of the territory is often negotiated in a multi-unit agreement. The territory size is generally tied to the development schedule and the initial fee paid to the franchisor. If a franchisee requests a larger territory, a franchisor will likely request a larger initial fee and a more aggressive development schedule. Both parties must be realistic in assessing the size of territory the multi-unit franchisee is able to develop given the resources available.

C. Reservation of Rights

Similar to a unit franchise agreement, under a multi-unit franchise agreement, a franchisor reserves certain rights in the multi-unit franchisee's territory including the right to develop at non-traditional sites and to use other channels of distribution. Multi-unit franchisees (especially international multi-unit franchisees) are often in a better position to negotiate limitations on the franchisor's reservation of rights than single unit franchisees. For example, if a franchisor is granting a multi-unit franchisee the right to develop units in a particular country, the multi-unit franchisee may attempt to limit the franchisor's ability to sell products using the brand via the Internet or other channels of distribution to customers located within that country. The multi-unit franchisee will argue that it is responsible for developing the brand within that country and should be able to control customer's access to any branded products in the country. The franchisor believes that it has independently developed these other channels of distribution and that these sales only serve to enhance and grow the brand in that country. The franchisor and multi-unit franchisee may agree to a compromise under which the franchisor agrees to share in a certain percentage of profits with the multi-unit franchisee for sales made to customers located in that country using an alternative channel of distribution.

Another negotiated area is non-traditional sites. If a multi-unit franchisee has the rights to develop a particular area or an entire country, the multi-unit franchisee will want the right to develop at any non-traditional site within that territory (such as airports). The franchisor will want to reserve the right to develop at those sites. These locations often require unique arrangements and can produce a high volume of sales. In addition, a single licensee may have the right to develop multiple concepts at the non-traditional site and the multi-unit franchisee would be effectively prohibited from developing a unit franchise at that site. The franchisor and multi-unit franchisee may agree that if the multi-unit franchisee is unable to develop a unit

franchise at a non-traditional site within the territory then the franchisor may pursue development at that site.

EXAMPLE – Negotiated Reservation of Rights. Franchisor (for itself and its affiliates) retains the right:

1. To itself operate, or to grant other persons the right to operate, Stores at locations outside the Territory;
2. To sell the products and services authorized for sale at Stores under trademarks and service marks other than the Marks through similar or dissimilar channels of distribution;
3. To itself own and operate, and to grant other persons the right to own and operate, Stores at Non-Traditional Locations ~~within or~~ outside the Territory on conditions as Franchisor deems appropriate, and at Non-Traditional Locations within the Territory only if a third party (not directly or indirectly controlled by or under common control with Franchisor or Franchisee) exercises control over the development of a site at a Non-Traditional Location (the “Site Developer”), and the Site Developer will not permit Franchisee to directly develop and operate a Store at the Non-Traditional Location;
4. To sell the products and services authorized for sale at Stores under the Marks through dissimilar channels of distribution (i.e., other than the operation of full-service retail Stores), including by electronic means such as the Internet and by websites established by Franchisor, and pursuant to conditions Franchisor deems appropriate within and outside the Territory; provided that if Franchisor sells products or services authorized for sale at Stores under the Marks via the Internet to customers located within the Territory, Franchisor will pay Franchisee 20% of the Net Proceeds of such sales; and
5. To advertise the System on the Internet (or any other existing or future form of electronic commerce) and to create, operate, maintain and modify, or discontinue the use of a website using the Marks.

D. Development Schedule

One of the most negotiated provisions in any multi-unit agreement is the development schedule. In determining the development schedule under any multi-unit agreement, a franchisor must balance the need to aggressively motivate the multi-unit franchisee to develop the territory with a realistic development schedule. Too often, both the franchisor and multi-unit franchisee believe that the multi-unit franchisee will be able to achieve an aggressive development schedule, and the multi-unit franchisee quickly runs into challenges including under-capitalization, inability to identify good locations, zoning, and other local considerations. In addition, a multi-unit franchisee likely wants more flexibility on how that development schedule is achieved. An alternative may be to agree to more limited development schedule with a smaller area development fee and territory, but give the multi-unit franchisee the right to develop additional units if it meets the initial development schedule. A realistic development schedule will set the parties up for a successful relationship.

The parties should also consider what happens if the parties fail to meet the development schedule. Many franchisors will reserve the right to either terminate the multi-unit agreement, or terminate any exclusivity in the territory but leave the multi-unit agreement in place. A multi-unit franchisee will want an alternative to simply terminating the agreement or territory exclusivity if it fails to meet a development schedule. A multi-unit franchisee may want the right to get a partial refund of the initial fee paid or an extended cure period if it fails to meet the development schedule. A franchisor and franchisee may find compromise in agreeing to an extension of the development schedule in exchange for an extension fee.

EXAMPLE – Negotiated Extension Fee. If Franchisee cannot comply with the Development Schedule, Franchisee may request in writing that Franchisor approve an extension of up to six (6) months of the time in which Franchisee must open a Store. Franchisee must pay Franchisor a nonrefundable extension fee of Two Thousand Hundred Dollars (\$2,000) when Franchisee requests an extension to the Development Schedule for any Store. ~~If Franchisor grants such an extension~~ The extension will be ~~limited to the period permitted by Franchisor not to exceed~~ six (6) months from the date the Store should have been open under the Development Schedule. Franchisee will not receive more than one (1) extension per Store (whether under this Agreement or the Franchise Agreement governing the Store).

1. Area Development Agreements

Under an area development agreement, the developer commits to signing a specific number of franchise agreements and developing those franchised units in a particular territory.¹⁰¹ Once those franchise agreements are signed, the area development agreement terminates and the developer's exclusivity is defined solely by the terms of the individual franchise agreements. As a result, a development schedule in an area development agreement generally focuses on the execution of individual franchise agreements or the number of franchised units open, rather than the cumulative number of franchised units open and operating in the territory. A developer may ask for flexibility under the development schedule, including the ability to obtain an extension to meeting the development schedule. In contrast a franchisor may want the developer to meet the development schedule or face termination of the area development agreement (including a forfeit of the development fees) in order to continue development in the territory with other prospective franchisees. Franchisor counsel and developer counsel will find it helpful to explore alternatives to a standard development schedule. For example, the parties could agree that if a developer fails to meet the development schedule, the exclusivity in a particular area terminates and the franchisor may begin developing franchised units in that area, but the developer still has the right to enter into the additional franchise agreements without forfeiting the development fee.

2. Area Representative Agreements

An area representative agreement generally contains a development schedule, although the form of the area representative development schedule can vary widely.¹⁰² A franchisor wants a development schedule that specifically describes the number of new franchised units

¹⁰¹ *Id.* at 14.

¹⁰² *Id.* at 15.

open in connection with the area representative's sales services and the cumulative number franchised units in operation during specific time periods. Since the franchisor has the ultimate decision about whether to sign a franchise agreement for a franchised unit in the territory, an area representative will want a more flexible schedule or even terms that allow the area representative to simply use its best efforts to recruit prospective franchisees. In addition, an area representative may want a franchisor to agree to offer a franchise to a prospective franchisee that meets certain defined qualifications, although a franchisor is unlikely to agree to such a provision that would limit its ability to reject a prospective franchisee.

3. Master Franchise Agreements

Under master franchise agreements, the development schedule sets forth a specific time period in which a certain number of franchised units must be open and operating. Most subfranchise development schedules list the both the number of new franchised units open in a particular time period and the cumulative number of franchised units operating in the territory at the end of such time period.¹⁰³ Master franchise agreements generally allow a franchisor to terminate the agreement or modify the territory if a master franchisee fails to meet the development schedule.¹⁰⁴

If the franchisor reserves the right to directly develop franchised units in the territory (for example through non-traditional sites), then the parties also will have to determine if these franchised units count towards a development schedule. A franchisor likely will not want these franchised units to apply toward the master franchisee's development schedule as the master franchisee did not assist in the development of such units, while the master franchisee will want any new units the franchisor develops to apply towards the development schedule because these franchised units are located in the master franchisee's territory.

Since a master franchise agreement generally covers larger geographic territories and contemplates significant development, there is more room for the parties to negotiate the development schedule and craft a reasonable solution for both the franchisor and master franchisee. For example, a franchisor may propose a development schedule with annual quotas of franchised units opened and cumulative number of franchised units operating. The franchisor reserves the right to terminate the franchise agreement immediately if the multi-unit franchisee fails to meet the development schedule. The master franchisee may counter with a development schedule that is evaluated once every five years and that allows the master franchisee to meet the development schedule by either meeting the number of new franchised units open or the cumulative number of franchised units operating. In addition, the master franchisee will want additional time to cure a default or an extension of the development schedule. Even when a franchisor and master franchisee view the execution of the development schedule differently, as in this example, the parties can generally find a workable solution.

¹⁰³ *Id.* at 14.

¹⁰⁴ *Id.*

E. Initial Fees

1. Area Development Agreements

Under an area development agreement, the developer pays the franchisor a nonrefundable area development fee for the right to enter into multiple single unit franchise agreements. The area development fee is generally based on the number of franchised units to be developed in the territory.¹⁰⁵ Some franchisors charge a non-refundable area development fee and then charge a standard initial franchise fee under each franchise agreement signed in connection with the development agreement. Other franchisors will apply all or part of the area development fee to the initial franchise fee owed under each franchise agreement. A developer will want all or some of the area development fee to be applied to the initial franchise fees due under the franchise agreements or allow for a refund of part of the area development fee if the franchised units are not developed. A franchisor views the development fee as a cost to keep the territory open for the multi-unit franchisee and may be reluctant to negotiate the area development fee unless the background of the developer and the development area justifies it. As mentioned above, one alternative for the franchisor and developer to consider is for the parties to agree to a conservative development schedule and more modest development fee up front, and then give the developer the right to extend the term if developer is in full compliance with the terms of the area development agreement by paying the franchisor additional development fees and committing to an additional development schedule.

EXAMPLE – Negotiated Option Period. Upon the execution of this Agreement, Area Developer shall pay Franchisor an amount equal to the sum of ~~-\$200,000~~ ;\$50,000. representing one-half of the Initial Fee (described in Section _____) multiplied by the number of Units required to be opened during the initial Term pursuant to the Development Schedule (the “Development Fee”). ~~The Development Fee~~ If Area Developer elects to extend the Term to include the First Option Term, then Area Developer shall pay an additional Development Fee of \$30,000 for the 3 Stores to be opened during the First Option Term. If Area Developer thereafter elects to extend the Term to include the Second Option Term, then Area Developer shall pay an additional Development Fee of \$30,000 for the 3 Stores to be opened during the Second Option Term. The Development Fee for the initial Term is fully earned upon the execution hereof, and, ~~subject to Section _____,~~ the Development Fee for the First and Second Option Terms is fully earned upon the exercise of the applicable option. The Development Fee is non-refundable ~~under any circumstances.~~ unless Franchisor has breached any of its material obligations under this Agreement or pursuant to Section _____ or Section _____. Franchisor will credit one-half of the Initial Fee for each Store paid as part of the Development Fee (“Development Fee Credit”) against the Initial Fee due at the time the Franchise Agreement for such Unit is signed until the entire Development Fee has been so credited. In no event will the total amount of such credits exceed the Development Fee paid by Area Developer to Franchisor hereunder.

¹⁰⁵ Woods & Yatchak, *supra* note 98, at 16.

2. Area Representative Agreements

Under an area representative agreement, the area representative pays the franchisor a nonrefundable initial fee for the right to recruit and service franchisees in a particular territory.¹⁰⁶ The initial fee may include the initial franchise fee for a franchised unit developed by the area representative or its affiliates. This is particularly true if the area representative is required to open a unit franchise under the area representative agreement. The area representative fee can vary widely depending on the size of the territory and the experience of the area representative, and is often negotiated by the parties. A franchisor that is just launching its area representative program also may waive the area representative fee in its entirety in order to attract qualified area representatives.

3. Master Franchise Agreements

Under a master franchise agreement, a master franchisee pays the franchisor a nonrefundable initial master franchise fee for the right to subfranchise in the territory. The initial master franchise fee varies and is widely negotiated, especially internationally. The parties will consider various factors including the experience of the master franchisee, the term, the territory to be developed, the number of franchised units in the development schedule, and the cost for the franchisor to enter the new market and assist the master franchisee.¹⁰⁷

F. Ongoing Fees

1. Area Development Agreements

While no ongoing fees are due under an area development agreement (except for a transfer fee or renewal fee), the area development agreement may prohibit the franchisor from changing certain fees under the unit franchise agreements. Under the area development agreement, the developer must sign the franchisor's then-current form of franchise agreement, which may include different fees and costs.¹⁰⁸ A franchisor wants that flexibility to change these fees as its fees and costs may change over time. In contrast, a developer will want the franchisor to commit to leaving the royalty fees, initial franchise fee, and certain other fees the same as the current form so that it has some certainty of its cost structure when developing the franchised units. A franchisor may agree to not change specific fees if the term of the area development agreement is short and the franchisor is relatively certain that its fees and cost structure will not change. If the area development agreement has a longer term, a franchisor is more likely to want the flexibility to change the fees. Franchisee counsel may consider requesting that certain fees get set for a certain number of years and that any increase in these fees is capped. In addition, a developer may want a lower initial franchise fee after it has opened a certain number of units in exchange for less initial training. A franchisor may agree to a lower franchise fee with reduced initial training, but it will want to ensure that the franchised unit managers are adequately trained by implementing a training program. A developer may also want to negotiate the transfer fee to allow for a reduced fee if the developer is transferring multiple units at the same time. The developer will want to avoid paying a large transfer fee, while a franchisor will want to be sure that if it agrees to a reduced franchise fee for transferring

¹⁰⁶ *Id.*

¹⁰⁷ *Id.* at 15.

¹⁰⁸ *Id.* at 16.

multiple units that the reduced fee only applies if the units are transferred in the same transaction and that the fee covers the franchisor's costs associated with the transfer, including legal costs and training costs.

EXAMPLE – Training Program for Lower Initial Franchise Fee. Franchisor will offer a “Trainer Program” to xxx® franchisees who have owned and operated a Store for a minimum of two years. If Franchisee desires to participate in this program, a member of its management team (who has successfully completed Franchisor's initial training program) will be entitled to complete Franchisor's training certification course and become a “Trainer.” Franchisor will not charge a separate training fee for one person to participate in its Trainer Program. If Franchisee or a member of its management team becomes a “Trainer,” all Franchise Agreements Franchisor and Franchisee subsequently enter into will be modified to reflect the following:

- (1) the Initial Franchise Fee for each such Franchise Agreement will be reduced to Ten Thousand Dollars (\$10,000);
- (2) the Trainer will conduct the initial training program that required attendees of each Store must successfully complete. In addition, the Certified Trainer must provide 3 to 5 days of opening support to assist Franchisee in the opening and initial operations of the Store. In doing so, the Trainer must comply with Franchisor's Store opening procedures and guidelines; and
- (3) this opening assistance will replace the opening support Franchisor otherwise would provide under the Franchise Agreement.

Franchisee understands that the Initial Franchise Fee modification described in subsection (1) above will remain in effect respecting all applicable Franchise Agreements only so long as Franchisee has a Trainer and each of Franchisee's Stores satisfies Franchisor's then-current standards for Store operations and service as further described in the Manual. If Franchisee fails to meet these conditions, the modifications described in subsection (2) above will be void as to all applicable Franchise Agreements and the modification described in subsection (1) above will be void as to all future Franchise Agreements.

2. Area Representative Agreements

One way that area representative agreements differ greatly from other multi-unit agreements is that the franchisor pays the area representative for its sales services and support services. The area representative is paid a percentage of initial fees and ongoing fees that is tied to the services that they perform under the area representative agreement.¹⁰⁹ Depending on the strength of the franchisee candidate, a franchisor may negotiate the percentage that the franchisor pays the area representative, although it is more likely that the franchisor will negotiate how payment is made. Most area representative agreements only obligate the franchisor to pay the area representative when the franchisor gets paid by the franchisee. The franchisor wants the area representative to be motivated to get the franchisees in its area to pay. In contrast, the area representative wants the franchisor to pay the commission when the

¹⁰⁹ *Id.*

amounts are due to the franchisor as only the franchisor can put the franchisee in default for non-payment of fees. Another area of concern for area representatives is the conditions for receiving payment. The fees are tied to certain services that the area representative must perform. Often the details of these services are described in the operations manual and it may not be clear to the area representative what it must do. The parties also will need to determine if the area representative will receive a percentage of royalty fees based on existing franchisees in the territory.

3. Master Franchise Agreements

Under a master franchise agreement, a master franchisee must pay the franchisor a certain percentage of ongoing fees that it charges its subfranchisees.¹¹⁰ The parties will negotiate the percentage of those fees and how the fees are calculated. For example, is the master franchisee obligated to pay the fees on amounts owed or amounts actually collected? A franchisor will want to base the fee on amounts owed because only the master franchisee has the ability to collect those fees from a subfranchisee. A franchisor will argue that if the fee cannot be based on amounts actually collected as it will have no recourse if a master franchisee does not aggressively collect fees or waives fees owed. A master franchisee will want to base the fee on amounts actually collected. If a subfranchisee is refusing to pay certain fees or unable to pay fees (such in a bankruptcy proceeding), the master franchisee does not want to be required to pay the franchisor when it cannot collect on those amounts itself.

Another consideration is whether the fee will be based on a flat percentage or based on the greater of a certain amount or the percentage. A franchisor will want the fee based on the greater of a certain amount or percentage because the franchisor wants certainty in its ongoing fees and if the master franchisee elects to discount the fees, it should not change the amounts owed the franchisor. The master franchisee will want the ability to charge discounted fees to encourage development in its territory while ensuring that it is able to keep a certain percentage of the fee to fund additional development. A compromise may be that the fee is based on the greater of a certain amount or a percentage, but keep the minimum amount lower.

EXAMPLE – Negotiated Initial Franchise Fee. Master Franchisee also will pay Franchisor a “Store Franchise Fee” equal to the greater of ~~Eight~~ Four Thousand U.S. Dollars (US~~\$8,000~~4,000) or twenty percent (20%) of the initial fee that Master Franchisee charges each Subfranchisee for each Store opened in the Territory. Master Franchisee also will pay Franchisor a Store Franchise Fee for each Store that Master Franchisee opens through a controlled subsidiary (as further described in Section __ below). Master Franchisee will pay Franchisor the Store Franchise Fee for a particular Store before or at the same time that Master Franchisee submits the then-current Master Franchise Agreement signed by Master Franchisee and Subfranchisee to Franchisor, both of which must take place before opening the Store.

G. Cross Default

A cross default provision is common in multi-unit agreements. A franchisor wants to motivate multi-unit franchisees to comply with the terms of all of their agreements, and will use a cross default provision to ensure that a multi-unit franchisee does not ignore its obligations under one agreement while still holding its rights under the remaining agreements. This

¹¹⁰ Woods & Yatchak, *supra* note 98, at 16.

provision presents risk to a multi-unit franchisee as a default under one agreement can put all agreements at risk, and the multi-unit franchisee will try to remove this provision or limit its application to the multi-unit franchisee only (and not the multi-unit franchisee's affiliates).¹¹¹ A multi-unit franchisee will want the right to close unprofitable unit franchises while being able to continue operating the successful units. A franchisor generally will refuse to modify this provision as it is such an effective tool for ensuring compliance across the system.¹¹² A franchisor may, however, be willing to add in a termination fee that would allow the franchisee to pay a fee in exchange for the right to terminate a franchise agreement without cause.

H. Rights Upon Expiration or Termination of the Multi-Unit Agreements

Most post-termination obligations under multi-unit franchise agreements are similar to those post-termination obligations under unit franchise agreements, although there are unique circumstances under master franchise agreements. Most master franchise agreements provide that the franchisor has the right, but not the obligation, to assume the master franchise agreements in the territory at the time of termination or expiration, effectively taking the place of the master franchisee.¹¹³ The agreement also may provide that the franchise agreements will be terminated if the franchisor does not want to assume those franchise agreements. Master franchisee counsel will not want the franchisor to have the right to terminate the franchise agreements upon expiration or termination of the master franchise agreement because it will be a significant hurdle in the sales process. A franchisor may not be willing to negotiate on this point if it does not feel it could comfortably step into the master franchisee's role under the unit franchise agreement.

I. Form of Unit Franchise Agreement under a Master Franchise Agreement

Under a master franchise agreement, a master franchisee must enter into unit franchise agreements with subfranchisees. The form of single unit agreement that the master franchisee must use is typically attached to the master franchise agreement. Alternatively, the master franchise agreement may include a list of items required to be included in the form of unit franchise agreement and require that the master franchisee get approval from the franchisor of the form of unit franchise agreement.¹¹⁴ A franchisor wants as much control as possible over the form of the unit franchise agreement to ensure that its system is uniformly imposed and for the franchisor to be comfortable if it takes over these agreements upon termination or nonrenewal of the master franchise agreement. A master franchisee may want more control to revise the form of unit franchise agreement to comply with local law, adapt the system to cultural differences in their territory, or to revise the unit franchise agreement to reflect terms that the master franchisee would like in the unit franchise agreement. For example, a master franchisee that is developing a concept that is new to a particular area may need to charge a lower initial fee to attract qualified candidates and to meet the development quota. Master franchisee's counsel will need to be prepared to articulate why any changes to the form subfranchise agreement are necessary or in the franchisor's interest. A franchisor will have to balance its

¹¹¹ Chernow, Olson & Prince, *supra* note 5, at 34.

¹¹² *Id.*

¹¹³ Woods & Yatchak, *supra* note 98, at 27.

¹¹⁴ *Id.* at 10.

need for uniformity and control with those needs of the master franchisee for flexibility to adapt the unit franchise agreement to meet its needs.

IV. SYSTEM-WIDE NEGOTIATIONS

Franchisors are often confronted with a dilemma: while the consumer public wants new and different products and services and as businesses and systems inevitably change over time, franchisees executing long-term contracts frequently assume that what they are purchasing will remain relatively constant throughout the business relationship.¹¹⁵ At the time of negotiation of the franchise agreement franchisors can reduce later hostility to system changes by advising franchisees that changes may be necessary in the future for the franchise to remain competitive. Franchisor counsel should point to the language in the franchise agreement which grants the franchisor the right to make system-wide changes from time to time.¹¹⁶ The franchisor's right to make changes to the concept is a core part of the long-term viability of the franchise, and often non-negotiable.

System-wide negotiations most often arise at times of stress, such as when there is widespread discontent among franchisees, major litigation, the sale of the system, or other events that could have a dramatic impact on the future of the system. Oftentimes, system-wide negotiations are best handled through a franchisee association; however, the association rarely has the full participation of franchise community. Negotiations are likely to involve both legal and business issues. However, gaining acceptance among the entire franchise community can be challenging. It is unlikely that all franchisees will agree on all forms of a new standard agreement or significant modifications to existing agreements. Some may be disinterested in any type of change, others may be satisfied with the current agreement, and franchisees often have different agendas and issues that concern them. Attorneys with extensive experience in negotiations for system wide changes point to the following issues that are likely to be discussed during the negotiating process: (a) royalty fees and advertising contributions; (b) territorial exclusivity; (c) post-term non-competes; (d) approved suppliers' rebates and general specifications of the items used in the franchise operations; (e) modifications that can be made to the operations manual; (f) franchise term renewals; (g) administration of the advertising program; and (h) the role of the franchisee association in connection with the franchise relationship.¹¹⁷

V. FDD DISCLOSURES FOR NEGOTIATED CHANGES

A. Impact of Negotiation on FDD Disclosure

When a franchisor is negotiating a franchise agreement, it must be aware that any negotiated change may have an impact on the disclosures contained in the FDD. Generally, FDD disclosures must be current as of the issuance date. As a result, most negotiated changes do not require any changes to the FDD. In particular, if a franchisor negotiates with a franchisee, a franchisor does not need to update its FDD to disclose the negotiated change for

¹¹⁵ Edward Dunham & Kimberly Toomey, *The Evolution of the Species: Successfully Managing Franchise System Change*, 24 FRANCHISE L.J. 231, 231 (2005).

¹¹⁶ *Id.* at 232.

¹¹⁷ Ted P. Pearce & Rupert M. Barkoff, *Collective Bargaining and the Franchise Agreement: Finding the Middle Ground*, A.B.A. F. ON FRANCHISING, 2001.

that franchisee or future prospective franchisees (except in California, as described below). If a franchisor negotiates certain terms of the franchise agreement, those negotiated changes may impact certain items in the next fiscal year's FDD.

In Item 5 of the FDD, a franchisor must disclose the initial fees that a franchisee must pay the franchisor or its affiliates. Initial fees include all fees and payments for services or goods paid by the franchisee to the franchisor or its affiliate before the franchisee's business opens.¹¹⁸ If the franchise fee is not uniform, the franchisor must disclose the range of fees paid in the previous fiscal year.¹¹⁹ If a franchisor has negotiated any initial fees during the past fiscal year, it must disclose that range and effectively put prospective franchisees on notice that these initial fees may be negotiable. A franchisor must remember that this obligation to potentially disclose a range of fees includes any fees paid to the franchisor or its affiliates before the franchise opens, including software fees or development fees.

In Item 6 of the FDD, a franchisor must disclose whether the fees that the franchisor charges are uniformly imposed.¹²⁰ If a franchisor negotiates a provision in the franchise agreement and the fees disclosed in Item 6 are not uniformly imposed, a franchisor must include a statement in Item 6 of the FDD that certain fees are not uniformly imposed. For example, if a franchisor agrees to waive a renewal fee, a franchisor must put prospects on notice that either the renewal fee is not uniformly imposed or a more general statement that certain fees are not uniformly imposed.

In Item 11 of the FDD, a franchisor must disclose the amount that a franchisee must contribute to a marketing fund and whether other franchisees must contribute a different rate or amount.¹²¹ If a franchisor negotiates the marketing fund contribution, it must include a disclosure that other franchisees may contribute the same or a different rate or amount.

B. Impact of Negotiation on Timing of FDD Disclosure

Under the FTC Franchise Rule, a franchisor has an obligation to provide a copy of the franchise agreement to a prospective franchisee at least seven calendar days before the prospect signs a binding agreement or pays a fee.¹²² This copy of the franchise agreement must have all material blanks completed in order to start the seven-day waiting period. Changes to the franchise agreement as a result of negotiations initiated by the prospective franchisee do not trigger a new seven-day waiting period.¹²³ For example, if a franchisor provides a prospective franchisee with its franchise agreement with all material blanks completed, including fees and the territory description, and the prospective franchisee asks for a modification of the agreement, by making such modification, the franchisor does not restart a new seven-day waiting period and may proceed with signing the franchise agreement upon completion of the initial seven-day waiting period.

¹¹⁸ 16 C.F.R. § 436.5(e) (2007).

¹¹⁹ *Id.* § 436.5(e).

¹²⁰ *Id.* § 436.5(f).

¹²¹ *Id.* § 436.5(k)(4)(v)(B)

¹²² *Id.* § 436.2(b).

¹²³ *Id.*

C. California Negotiated Change

If a franchisor is negotiating a franchise agreement with a franchisee that is protected by the California Franchise Investment Law (“CFIL”), the franchisor must be aware that without an available exemption, a franchisor may only offer and sell a franchise using the franchise agreement that was registered with the California Department of Business Oversight (“DBO”) as part of the registered FDD. As a result, if a franchisor wants to sell a franchise with terms that are different than the registered franchise agreement, it must use one of two exemptions available under the CFIL or amend its FDD with the DBO.

Under the CFIL, franchisors that negotiate the terms of the registered franchise agreement must provide the prospect with a “*summary description of each material negotiated term that was negotiated by the franchisor for a California franchise during the 12-month period ending in the calendar month immediately preceding the month.*”¹²⁴ A “material” term is a term that a “*reasonable franchisee would view the terms as important in negotiating the franchise.*”¹²⁵ This supplemental statement is provided in addition to the FDD and must notify the prospective franchisee that copies of the actual negotiated terms are available upon written request.¹²⁶ A franchisor also must certify in its application for renewal with the DBO that the franchisor has complied with this law, but it does not require that the franchisor file a copy of the supplemental disclosure with the DBO.¹²⁷ These additional disclosures are only required when a franchisor negotiates with a prospective franchisee. If a franchisor does not negotiate with a prospective franchisee, no additional disclosures are required.¹²⁸ This option is only available when “*the negotiated terms, on the whole, confer additional benefits on the franchisee*”(emphasis added).¹²⁹

As an alternative to the process described under the CFIL, a franchisor may follow the procedure described in the CFIL regulations (the “Regulations”). Under the Regulations, a franchisor must notify the DBO that a negotiated change has occurred by filing a “Notice of Negotiated Sale of Franchise” within 15 days following the sale.¹³⁰ A franchisor also must formally amend its registered FDD to include a copy of all Notices of Negotiated Sale of Franchise during the last 12 months.¹³¹ As a result, all prospective franchisees will receive a summary of the negotiated sales with California prospects during the last 12 months.¹³²

¹²⁴ CAL. CORP. CODE § 31109.1.

¹²⁵ *Id.*

¹²⁶ *Id.*

¹²⁷ *Id.*

¹²⁸ Matthew J. Kreutzer, *Negotiated Sales in California*, FRANCHISE LAW., Spring 2012.

¹²⁹ CAL. CORP. CODE § 31109.1.

¹³⁰ CAL. CODE REGS, tit. 10 § 310.100.2.

¹³¹ CAL. CODE REGS, tit. 10 § 310.100.2.

¹³² Kreutzer, *supra* note 125.

Given the two options, most franchisors elect to comply with the additional disclosure and certification filing described under the CFIL rather than the requirements under the Regulations, however, if the negotiated terms do not, on a whole, confer additional benefits on the franchisee, then the franchisor must comply with the more onerous Regulations. Due to the additional disclosure and filing requirements, many franchisors are reluctant to negotiate with California prospects at all. As many franchisors may not fully understand or comply with this regulation under the CFIL, franchisee counsel should ask if a franchisor negotiated within the past 12 months.

D. California Material Modification of Existing Franchise

A franchisor with a California franchisee must be aware that even if the franchisor does not negotiate with the franchisee before it purchases the franchise, it may be subject to the CFIL if the franchisor and franchisee negotiate the franchise agreement during the term of the franchise agreement. Under the CFIL, if there is a “material modification” to an existing franchise, the franchisor must complete a filing with the DBO and provide additional disclosure unless exempt from the filing.¹³³ A franchisor will be exempt from the required filing under the Regulations if it meets one of the following conditions:

- (1) The proposed modification is on a “voluntary basis and does not substantially and adversely impact the franchisee’s rights, benefits, privileges, duties, obligations, or responsibilities under the franchise agreement.”¹³⁴
- (2) The franchisor complies with the following: (a) identifies the proposed modification either five business days before the franchisee signs a binding agreement or provides the franchisee with a statement informing the franchisee that it may rescind the modification within 5 business days after signing a binding agreement; (b) the modification is not signed within 12 months after the franchise agreement is signed; (c) the modification does not waive any right under the California Franchise Relations Act; and (d) the modification is either made in connection with a bona fide dispute and not applied on a systemwide basis (less than 25% of California franchisees within any 12-month period) or offered on a voluntary basis to less than 25% of California franchisees within any 12-month period.¹³⁵

Most material modifications during the term of a franchise agreement will meet one of the two exemptions described above.

E. Virginia Requirement to Negotiate

The Virginia Retail Franchising Act (“VRFA”) has a unique provision that allows a franchisee to void the franchise agreement if the franchisee is not given the opportunity to negotiate the franchise agreement. Under the VRFA, a franchisee may void the franchise if the “franchisee was not afforded the opportunity to negotiate with the franchisor on all provisions within the franchise, except that such negotiations shall not result in the impairment of the

¹³³ CAL. CORP. CODE § 31125(a); CAL. CODE REGS, tit. 10 § 310.125.

¹³⁴ CAL. CORP. CODE § 31125(d).

¹³⁵ *Id.* § 31125(c).

uniform image and quality standards of the franchise.”¹³⁶ In order to void the franchise, a franchisee must send the franchisor a written declaration within 30 days after signing the franchise agreement.¹³⁷ In practice, while franchisees must have the opportunity to negotiate, there is no requirement that the franchisor actually agree to revise any provision of the franchise agreement. A franchisor must ensure that it is not informing prospective franchisees in Virginia that the franchisor will not negotiate. Franchisee counsel may use this provision to engage franchisor counsel in negotiation, particularly when franchisee counsel can argue that the provision does not impact the “uniform image and quality standards of the franchise.”

VI. NEGOTIATING TIPS

Assuming that the franchisor is amenable to negotiating, as with any types of negotiations, much will depend on the bargaining strength of the parties. The party who is willing to walk away from the deal without looking back is typically in a strong bargaining position. The authors of an earlier ABA Forum paper on negotiating suggest that the factors that can influence the ultimate outcome are: (a) knowledge and understanding of the other parties’ perspective; (b) research with current franchisees; (c) franchisee counsel experiences; (d) careful review of specific language in the agreement; (e) review of previous versions and other systems; and (f) market forces.¹³⁸ Among specific factors that are particularly applicable to negotiating franchise agreements are:

1. Address “deal breakers” promptly and be willing to walk away if one or more is critical.
2. Be reasonable and pick your battles. An attorney for a franchisee who presents a laundry list of proposed changes, will likely be viewed as inexperienced in franchising, and the franchisor may be inclined to summarily reject all changes.
3. Recognize the franchisor’s need to maintain system standards and to protect its brand. A franchisor that enforces system standards and requires franchisees to make necessary modifications to adapt and keep up with the times, will generally be more successful. Non-compliant franchisees are bad for the system.
4. Recognize that it can be a nightmare for a large franchisor to administer many different forms of franchise agreements, and a franchisor will be very reluctant to negotiate anything that presents an administrative burden or requires the franchisor to institute different or additional procedures in order to administer the agreement.
5. Compare other franchises in similar lines of business.
6. Look for consistency across franchise agreements. Franchisees should contact other franchisees to see if they are willing to share if they’ve had success in negotiating with the franchisor. The franchisee may discover what’s possible or that efforts to negotiate will be pointless. The franchisor should aim for consistency in how and what it will negotiate in franchise agreements.

¹³⁶ VA. CODE ANN. § 13.1-565.

¹³⁷ *Id.*

¹³⁸ See Chernow, Olson & Prince, *supra* note 5, at 36-38.

7. Understand each party's legitimate business interests. Franchisors must disclose special deals or terms they negotiate under certain circumstances or with selected parties, and generally want to avoid negotiating changes that would trigger a disclosure obligation, unless there is a legitimate business interest for doing so. Franchisees who can make a business case for the negotiated changes are more likely to be successful in their negotiations.
8. Understand your own bargaining power (or lack thereof). If a franchisor negotiates too many special deals, it can breed discontent amongst franchisees who did not receive the same special deal, unless the franchisor has a legitimate business justification. If the franchisee doesn't bring the same benefits or attributes to the table or is not "similarly situated," they likely will not receive any specially negotiated deals. Franchisors who don't take into account the business interests and unique qualifications of franchisees, may have a difficult time finding the most desirable franchisees. And, of course, if the franchise is a particularly sought after "hot" concept, the franchisor will have significant bargaining leverage.

VII. CONCLUSION

Regardless of the extent to which a franchisor is willing to negotiate, in today's legal and business environment, the reality is that franchise agreements will remain skewed in favor of the franchisor. In some cases, the process of negotiation may lead the prospective franchisee to realize that he or she is not prepared to take on the significant risks and obligations of owning a franchise. Ideally, the negotiating process will help both parties understand each other's legitimate business and legal concerns and focus on those issues that are truly important. It may also provide an opportunity for each to better understand one another and sometimes help the parties realize that they are not the ideal fit.

ELIZABETH DILLON

Liz Dillon is a principal with Gray Plant Mooty in Minneapolis, Minnesota. With over a decade of experience, Liz counsels growing and experienced franchisors to expand and maintain their franchise systems. She assists start-up franchisors to develop and position their franchise systems for growth both domestically and internationally.

Liz typically manages the franchise registration process for more than 45 well-known brands every year and has worked with over 20 start-up franchisors. She has helped franchisors expand into Latin America, the Caribbean, Asia, Europe, and the Middle East. She brings extensive knowledge and experience in preparing and registering disclosure documents, as well as franchise, development, and supply agreements.

Clients value her ability to provide real-life solutions to challenging problems. They depend on her responsive and pragmatic, yet creative, advice. Liz has been recognized as a "Legal Eagle" by *Franchise Times*, honored as a "Minnesota Rising Star" by peers, recognized by *Chambers USA* and *Chambers Global*, and acknowledged as an "Up and Coming Attorney" by *Minnesota Lawyer*. In addition, she has earned the Certified Franchise Executive designation from the Institute of Certified Franchise Executives.

LEONARD D. VINES

Leonard D. Vines is an officer and shareholder in the St. Louis office law firm of Greensfelder, Hemker and Gale, P.C. He concentrates his practice in franchise and distribution. Mr. Vines is listed in the *Chambers USA* (Leading Franchise Lawyers nationwide), *Best Lawyers of America*, the *International Who's Who of Franchise Lawyers*, *Who's Who in American Law* and *Kansas Missouri Super Lawyers*. Mr. Vines is a former member of the Governing Committee of the American Bar Association Forum on Franchising, and a member of the franchise advisory board of the North American Securities Administrators Association (NASAA). He is a panel member of the Westlaw Round Table Group Expert Network, served as a member of the IFA Legal Symposium Planning Committee, and is an Editorial Board Member for *LJN's Franchising Business & Law Alert*. He is also a frequent lecturer on franchise topics for various organizations and has spoken at programs sponsored by the American Bar Association Forums Committee on Franchising, International Franchise Association, the Bar Association of Metropolitan St. Louis, Missouri Bar and the National Franchise Law Institute. He served as co-editor for the American Bar Association publication, *Mergers and Acquisitions of Franchise Companies* 2nd Edition and co-author of a chapter for *The FTC Rule*. He has also written articles for various legal publications such as the *ABA Journal*, *The Franchise Lawyer*, *Journal of the Missouri Bar*, *St. Louis Bar Journal*, *LJN's Franchising Business and Law Alert* and the *Franchise Law Journal*. Mr. Vines graduated from the University of Illinois with a B.S. in accounting with honors and from Washington University School of Law.

SUSAN TEGT

Susan Tegt is Corporate Counsel for Self Esteem Brands, LLC, the parent company of two franchise brands, Anytime Fitness and Waxing the City. Prior to joining Self Esteem Brands, Susan worked as a litigation attorney at the Bloomington, Minnesota, law firm Larkin Hoffman Daly & Lindgren, Ltd., focusing her practice substantially on franchise litigation matters venued in state and federal courts and in arbitration. Susan has been involved with the ABA Forum on Franchising for several years and is an active member of the Forum's Women's Caucus and is a repeat author for the *Franchise Lawyer*. Susan is also a member of the International Franchise Association's Legal Symposium Task Force and has presented at the IFA's Legal Symposium. Susan has been recognized as a 2014 Super Lawyer Rising Star in Minnesota.