

**FRANCHISE AGREEMENT DRAFTING**

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## **I. INTRODUCTION**

The franchise agreement is the most basic element of a franchise relationship from counsel's point of view. As with any other contract, it establishes the standards of performance of the parties and sets the tone for the relationship. The franchise agreement is also a complex document that must take into account the unique legal environment under which franchising operates in the United States and anticipate potential areas of dispute that may not become apparent until many years after execution. Any transactional attorney who has practiced and honed his trade should be able to produce a contract that establishes standards of performance and sets the desired tone for the franchise relationship. But, without a background in franchise law, they might not appreciate nuances in various state laws or they may not foresee nascent areas of conflict that could be avoided (or at least managed) with proper drafting. Similarly, a franchise lawyer who is not practiced in contract drafting may produce a contract that creates areas of uncertainty with regard to the parties' responsibilities under the franchise agreement.

This paper is intended to address some of the basic issues that arise in drafting franchise agreements. It is the authors' hope that this paper will be a resource for those attorneys who have been called on to draft a franchise agreement for the first time and for those non-lawyers who have been asked to oversee the preparation or revision of a franchise agreement.

We have divided this paper into three areas, each of which represent a critical aspect of franchise agreement drafting. Section II (Drafting and Construction) discusses the need for precision in drafting and the role that the canons of construction and the covenant of good faith and fair dealing play in the interpretation of the franchise agreement. Section III (The Manual) describes the unique role that the operations manual plays in the drafting of the franchise agreement and offers some practical observations about the issues should be addressed in the franchise agreement and those that should be addressed in the operations manual. Finally, Section IV (Common Provisions) highlights some of the more common clauses found in the franchise agreements and identifies some specific drafting issues related to each.

## **II. DRAFTING AND CONSTRUCTION**

While creativity is a positive attribute, the franchise agreement is not an appropriate venue for expression. The purpose of a franchise agreement is to state the parties' intentions. To accomplish this end, terms must be used properly, consistently and precisely. This section discusses the importance of clear and unambiguous drafting and the canons of constructions that come into play when a contract provision is missing, ambiguous or vague. It also contains general drafting suggestions and sample definitions for terms commonly used in franchise agreements.

## A. Contract Interpretation

### 1. Generally.

Contract interpretation generally is accomplished through a tiered approach:

- a. Where a contract itself is unambiguous, its meaning must be determined from the four corners of the instrument;
- b. Where ambiguity exists, traditional contract and statutory canons of construction may be used to determine the parties' intent (see II.A.2., below);
- c. Where ambiguity exists, parol evidence (including evidence concerning prior course of dealing) may be considered to determine the parties' intent; and
- d. Where a party does not have the express right to act, or has discretion in acting, the implied covenant of good faith and fair dealing may impose upon the party a duty to act in good faith (see II.A.3., below).

### 2. Canons of Construction.

Where terms are ambiguous or vague, the following canons of construction may be applied to determine the parties' intent:

- a. *Common Meaning.* Unless otherwise defined, words will be interpreted as having their ordinary, contemporary, common meaning.
- b. *Against the Drafter.* When a contract term is ambiguous, any ambiguity will be construed against the drafter.
- c. *Ejusdem Generis.* When general words follow an enumeration of persons or things of specific meaning, the general words will be construed as applying only to persons or things of the same general class as those enumerated. For example, when interpreting the term "oranges, lemons, and all other fruit," a court, relying on the canon of ejusdem generis, might conclude that "all other fruit" is limited to all other citrus fruit.

### 3. Covenant of Good Faith and Fair Dealing.

In many jurisdictions,<sup>1</sup> franchise agreements contain an implied covenant of good faith and fair dealing. In these jurisdictions, a party may breach the covenant of good faith and fair dealing even if the party's conduct does not contravene the express provisions contained in the four corners of the contract.<sup>2</sup> Several courts have held, however, that there can be no breach of an implied covenant of good faith and fair dealing where a party to a contract does what provisions of the contract expressly give him the right to do.<sup>3</sup>

## B. Drafting Practices

### 1. Objectives.

The two major objectives of drafting a franchise agreement, therefore, are (1) to avoid resort to canons of construction and extrinsic evidence by drafting clearly and unambiguously; and (2) to ensure that your client has the express right to do whatever it may in the future need to do.

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<sup>1</sup> A majority of states recognize the duty to perform a contract in good faith as a general principle of contract law. However, a small minority of states, while recognizing the covenant of good faith and fair dealing, explicitly require an affirmative showing of bad faith. Other states, such as Texas and New Mexico, only acknowledge the implied covenant in contracts involving special relationships, such as a fiduciary or insurance relationship. Tractenberg, et al, *What Is Left of the Doctrine of Good Faith and Fair Dealing?*, 36th Annual IFA Legal Symposium (May 11-13, 2003) (citations omitted). See also *Crim Truck & Tractor Co. v. Navistar Int'l Transp. Corp.*, 823 S.W.2d 591, 595-96 (Tex.1992) (declining to extend covenant of good faith and fair dealing to franchise agreements, where no special relationship exists between the parties because a franchisor does not exert control over its franchisee's business comparable to the control an insurer exerts over its insured's claim).

<sup>2</sup> *Bear, Stearns Funding, Inc. v. Interface Group-Nevada, Inc.*, 2005 WL 639419 (S.D.N.Y. March 21, 2005) (under New York law, all contracts contain an implied agreement that neither party may engage in conduct which would interfere with the other party's right to realize the benefit of the bargain, even if such conduct is not specifically prohibited by the contract). See also *Sons of Thunder, Inc. v. Borden, Inc.*, 148 N.J. 396, 420-21 (1997) (a defendant may be liable for a breach of the covenant of good faith and fair dealing even if it does not violate an express term of a contract). But see *Burger King v. Weaver*, 169 F.3d 1310 (11th Cir.1999) (holding that, under Florida law, an action for breach of the implied covenant of good faith cannot be maintained in the absence of breach of an express contract provision).

<sup>3</sup> See generally, Section III.B., below.

## 2. Avoid Vagueness Where Appropriate.

Vagueness in contract provisions derives from words and phrases that rely on context for their meaning.

Vague terms, such as “continuous” and “repeated,” to the extent practicable, should be replaced by terms designating a specific number of instances within a prescribed period of time (for example, the franchisor may terminate the franchise without opportunity to cure if the franchisee has received three or more notices of default within any 12-month period).

They also include “efforts” clauses, such as those requiring the parties to use “full time” or “best” efforts to achieve a objective (such as finding a location for the franchised business or promoting the sale of the franchisor’s products or services).

Vague provisions essentially serve two purposes in contract drafting. First, they comfort the parties by softening absolute obligations (such as a requirement to pay reasonable fees, rather than all fees) and tethering a party’s absolute right to act or to refrain from acting (the franchisor shall not unreasonably withhold its consent). Second, they provide a shortcut for addressing situations with multiple variables (for example, imposing a reasonableness standard may be more efficient than listing all of the conditions under which the franchisor may withhold its consent to a transfer).

On the other hand, vague provisions may end in disagreement, making it harder to prove that a party has, in fact, breached an obligation or failed to satisfy a condition. For example, many franchise agreements provide for termination without opportunity to cure if the franchisee “repeatedly” breaches the franchise agreement. Because the term “repeatedly” would be subject to interpretation by a judge or arbiter in the event of a controversy, prudent franchise counsel would advise her client not to terminate the franchise agreement based on default of this provision alone – essentially rendering the provision useless.

## 3. Avoid Ambiguity.

Unlike vague terms, ambiguous provisions serve no beneficial purpose and often lead to disagreement between the parties. A contract provision is ambiguous if it is capable of having two or more inconsistent meanings. In the context of a franchise agreement, for example, the term “exclusive territory” is ambiguous because “exclusive” can mean: (1) the franchisor will not award other franchises in the territory; (2) will not itself operate a similar business in the territory; (3) will not distribute its products or services through other channels of distribution in the territory; or (4) any or all of the above.



Inconsistent provisions in a franchise agreement also result in ambiguity. In *Carvel Corporation v. Baker*,<sup>4</sup> for example, the court held that the franchise agreement “Acknowledgements” section (which expressly contemplated distribution of Carvel products through “a *unique system* for the production, distribution, and merchandising of Carvel products”) conflicted with the reservation of rights clause (under which Carvel reserved for itself all rights to the Carvel trademarks). This conflict rendered the latter provision ambiguous as to whether it authorized distribution of Carvel products through supermarkets and ice cream vendors other than its franchisees. As a result, the court declined to hold, as a matter of law, that Carvel’s supermarket program did not violate the terms of the franchise agreement.

In *Stephens v. TES Franchising, et al*,<sup>5</sup> the court declined to enforce an arbitration provision where a conflicting provision in the franchise agreement stated that the parties “[agree] to submit any disputes between them to the jurisdiction and venue of a court of competent jurisdiction in the State of Connecticut, New Haven County.” Despite the Federal Arbitration Act’s strong presumption of arbitration, the court construed the ambiguity against the franchisor and denied its motion to compel arbitration.<sup>6</sup>

Finally, avoid use of prefatory language when introducing an obligation. Statements that precede obligations (for example, “in order to maintain uniform standards of appearance, franchisor may require franchisee to purchase supplies from approved or designated vendors”). In addition to being unnecessary and superfluous, it raises an issue as to whether the obligation that following the language is unconditional or whether it is conditioned on it furthering the franchisor’s stated objective. In other words, if the stated purpose of a supplier restriction is to ensure uniformity, must a franchisee comply with supplier restrictions imposed for a different purpose, for example obtaining volume discounts?

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<sup>4</sup> 79 F. Supp. 2d 53 (D. Conn. 1997).

<sup>5</sup> 2002 WL 1608281 (D. Conn.).

<sup>6</sup> In this case, the arbitration provision appeared under a section entitled “Arbitration” and the litigation provision under a section entitled “Miscellaneous.” Because another provision stating “[t]he titles and subtitles of the various articles and paragraphs of this Agreement are inserted for convenience and shall not be deemed to affect the meaning or provide guidance as to the construction of any of the terms of this Agreement,” the court held that the section titles “Arbitration” and “Miscellaneous” were “of no assistance in resolving the issue of whether there exists an enforceable agreement between the parties to arbitrate claims.” 2002 WL 1608281, *supra*, note 5.

#### 4. Use Defined Terms.

By dedicating a portion of the franchise agreement to important definitions, you can avoid ambiguity and the need for the fact finder to go through the exercise of determining the meaning of a term. For example, terms such as “trade secrets” and “confidential information” are used extensively to refer to a franchisor’s intellectual property and know-how. Absent a contractual definition, however, a fact finder called upon to interpret the meaning of any of these terms may resort to common or legal definitions. Thus, while a franchisor may intend the term “trade secrets” to include customer contact information, this type of information may not fall within definition of “trade secrets” under the laws governing interpretation of the agreement. To avoid ambiguity, therefore, the franchise agreement should expressly define “trade secrets” to include customer contact information, if that is what the parties intend.

Similarly, the term “good faith” can have several different legal meanings. “Good faith,” as defined by the Uniform Commercial Code, for example, means “honesty in fact” and “the observance of reasonable commercial standards of fair dealing.” “Good faith” performance or enforcement of a contract has been described to “[emphasize] faithfulness to an agreed common purpose and consistency with the justified expectations of the other party.”<sup>7</sup> The covenant of good faith and fair dealing calls for parties to a contract to refrain from doing “anything which will have the effect of destroying or injuring the right of the other party to receive” the benefits of the contract.<sup>8</sup> Before agreeing to modify an agreement with a duty of good faith, therefore, the parties should include in the agreement a written definition of what is meant by the term.

Other terms often worthy of definition include the franchisor’s “system” (especially if the franchisor represents that it will not operate or grants others the right to operate a similar business using the “system”), “affiliate” (a common control definition is standard, however, a more expansive definition may be appropriate under some circumstances), and “principal” (should the term include only those with an equity interest in the franchise, or should it also include officers, directors and other executives of the franchisee?).

An index of sample definitions is appended to this paper. Keep in mind, however, each franchise system is unique; therefore, definitions should be drafted to meet specific needs.

#### 5. State that the Franchise Agreement Was Jointly Drafted.

Because ambiguous terms, under traditional canons of construction, are to be construed against the drafter, many franchisors include in their franchise agreements a

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<sup>7</sup> Restatement (Second) of Contracts, § 205 (comment a).

<sup>8</sup> *Palisades Props., Inc. v. Brunetti*, 44 N.J. 117, 130, 207 A.2d 522 (1965); *Wade v. Kessler Institute*, 172 N.J. 327, 340, 798 A.2d 1251 (2002).

representation that the agreement was jointly drafted by the franchisor and the franchisee. These clauses also typically instruct the trier of fact, if presented with an ambiguity, not to construe the agreement for or against a particular party.

The following are typical provisions:

Franchisee acknowledges that it had the opportunity to be represented by an attorney in connection with the preparation and execution of this Agreement, and to review and understand the terms hereof and to consider the advisability of entering into this Agreement. This Agreement shall be construed according to its plain meaning and neither for nor against either party hereof regardless of which party's counsel drafted the provision.

Neither this Agreement nor any uncertainty or ambiguity herein shall be construed or resolved against the drafter hereof, whether under any rule of construction or otherwise. On the contrary, this Agreement has been reviewed by all parties and shall be construed and interpreted according to the ordinary meaning of the words used so as to fairly accomplish the purposes and intentions of all parties hereto.

6. Define Reasonable Exercise of Discretion.

If the franchise agreement permits the franchisor to act unilaterally or to use discretion in acting (which are typical rights under any franchise agreement), it is prudent to direct the trier of fact through the inclusion of a provision such as the one below.

The parties acknowledge that various provisions of this Agreement specify certain matters are within Franchisor's discretion or judgment, or otherwise are to be determined unilaterally by Franchisor. If the exercise of Franchisor's discretion or judgment as to any such matter is subsequently challenged, the parties expressly direct the trier of fact that Franchisor's reliance on a business reason in the exercise of its discretion or judgment is to be viewed as a reasonable and proper exercise of such discretion or judgment, without regard to whether other reasons for its decision may exist and without regard to whether the trier of fact would independently accord the same weight to the business reason.



## 7. Use a Carefully Drafted Integration Clause.

Despite that it is typically buried deep in the “Miscellaneous” section of a franchise agreement, the integration clause – at least from a litigation perspective – arguably is the most important provision in a franchise agreement.

A typical integration clause looks something like the following:

This Agreement constitutes the entire agreement between the parties concerning the subject matter of the franchise and supersedes all prior agreements. It may be modified only by a written document signed by both parties.

Franchise attorneys have successfully used integration clauses, coupled with disclaimers and “no reliance” clauses, to defeat common law and statutory fraud claims based on pre-sale representations.<sup>9</sup> Integration clauses and disclaimers are particularly effective where a fully integrated contract contradicts the alleged prior representation; however, integration clauses also have been held to bar claims where fully integrated agreements were silent as to the subject matter of the alleged representation.<sup>10</sup> A carefully worded integration clause, therefore, is important to protect the contents of the written agreement from collateral attack.

Integration clauses also have been used to defeat claims that the franchise agreement includes a franchisor’s internal policies and prior course of dealing.<sup>11</sup>

## 8. Use Illustrative Rather than Exhaustive Examples.

When drafting a franchise agreement, you will often have to include examples to describe a category of items. When doing so, placing the word “including” at the beginning of the list may help to describe the items, but may be considered an exhaustive list of items within that category. As it is impractical that you will be able to include every item for a particular category that needs mentioning in the franchise

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<sup>9</sup> Blum, et al, *Integration and “No Reliance” Clauses vs. Fraud and Other Claims*, IFA 32nd Annual Legal Symposium (May 23-25, 1999).

<sup>10</sup> *Id.*

<sup>11</sup> See e.g. *Nibeel v. McDonald’s Corporation*, 1998 WL 547286 (N.D. Ill.) (franchisee unsuccessful in claims that franchise agreement incorporated by reference the franchisor’s internal impact policy); *Payne v. McDonald’s Corporation*, 957 F.Supp. 749 (D.Md. 1997) (same). See also *Harford Donuts, Inc. v. Dunkin’ Donuts Inc.*, 2001 WL 403473 (D. Md.) (holding that franchisor’s impact policy did not become an enforceable part of the franchise agreement because it was not a signed writing, as required by the franchise agreement).

agreement, use the phrases “including without limitation” or “including but not limited to” to indicate that the list is merely illustrative and not exhaustive.

#### 9. Be Careful with Choice of Law Provisions.

Finally, be careful when drafting choice of law provisions, especially where the law of the chosen state includes franchise legislation. Although courts rarely apply state laws where the definitional elements of the law are not independently met, a handful of courts have extended the protection of a chosen state’s franchise law beyond jurisdictional limits to cover the parties and transaction at issue. In these cases, the courts focused not on whether the legislature intended the law to apply extraterritorially, but whether the parties intended their choice-of-law provision to serve as a “short-hand means of incorporating numerous contractual terms” as set forth in the chosen state’s law.<sup>12</sup>

### III. THE MANUAL

Preservation of uniformity and standardization within the system is highly prized by franchisors. Also, the reputation, image and goodwill of the system depend on the franchisor’s ability to uphold its quality standards and specifications by requiring franchisees to adhere to the franchisor’s directives in these areas. At the same time, the franchisor’s system may evolve over time and the ability to adapt to change, and to require franchisees to correspondingly adapt, may also be vital interests. The franchise agreement, as a bi-lateral contract, generally cannot be amended unilaterally. Thus, inclusion of detailed operational standards in the franchise agreement itself is generally not desirable and often is impractical due to the volume of materials and desired confidentiality of the details of the franchisor’s operating system.

A typical approach is to include in the franchise agreement a reference to the franchisor’s operations manual, along with a requirement that the franchisee abide by the strictures of the operations manual. Franchisors sometimes will even incorporate

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<sup>12</sup> See *Boatland, Inc. v. Brunswick Corp.*, 558 F.2d 818, 822 (6th Cir. 1977) (non-Wisconsin plaintiff has claim under Wisconsin franchise statute in light of contractual choice of Wisconsin law as governing); *C.A. May Marine Supply Co. v. Brunswick Corp.*, 557 F.2d 1163, 1166-67 (5th Cir. 1977) (same); *Mon-Shore Mgmt., Inc. v. Family Media, Inc.*, 584 F.Supp. 186, 193 (same, New York choice-of-law provision); *Dep’t of Motor Vehicles v. Mercedes-Benz of N. Am., Inc.*, 408 So.2d 627, 630 (Fla.App. 1981) (same, New Jersey choice-of-law provision); see also *Infomax Office Sys., Inc. v. MBO Binder & Co. of Am.*, 976 F.Supp. 1247, 1254 (S.D.Iowa 1997) (choice-of-law provision designating Illinois law creates cause of action under Illinois statute for non-Illinois plaintiff only to extent that statute does not conflict with terms of contract); *Peugeot Motors of Am., Inc.*, 892 F.Supp. at 360-62 (Hall, J., concurring in part and dissenting in part).

the operations manual into the franchise agreement by reference. The typical operations manual reference also provides that the franchisor may revise and update the operations manual from time to time. This maintains the desired flexibility for change and evolution in the system but may raise issues as well. Is there a limit to what can be placed in the operations manual (and thus be subject to unilateral change by the franchisor)? Is there greater difficulty in achieving judicial enforcement of the contract when the salient issue is part of the operations manual rather than an express provision of the franchise agreement?

In this section, we review and analyze some of these issues and discuss the effect these issues may have on drafting the franchise agreement. In many cases, there is not a single, or bright-line, answer. Each set of facts must be considered in its own context, with the franchisor's subjective weighting of its interests often playing as great a role as statute or case law. In a similar vein, the types of issues that we have identified and discuss can by no means be considered exhaustive but are illustrative of some of the more commonly encountered points of consideration.

#### **A. Flexibility**

Most franchise systems consist, in part, of a detailed set of standards, specifications, procedures or other protocols, such as: employee uniforms; marketing and advertising procedures; detailed operations procedures (e.g. specific temperatures for cooking and/or storing food items); standards for signs and other displays of the franchisor's trademark. In each case, the franchisor has an interest in requiring its franchisee to adhere to all of these policies and procedures. Yet, it is impractical to include all of these detailed requirements in the franchise agreement. One problem is in creating a franchise agreement of unwieldy volume. More importantly, putting all of this detail into the franchise agreement limits the franchisor's ability to change the requirements, possibly inhibiting the system's capability of adapting to changes in the marketplace, growth of the system (additional or new products or services) or other developments (improved techniques or know-how, enhancement or updating of the image of the system, or other improvements). Finally, because the franchise agreement is typically for an extended duration, the franchisor must have the ability to respond to market forces, technological developments and other issues that could not be contemplated at the time of signing.

The desired flexibility is often achieved by putting all the detailed operating procedures, standards and specifications in an operations manual. The franchise agreement contains a provision obligating the franchisee to adhere to the operations manual and permitting the franchisor to amend, supplement or revise the operations manual from time to time. Extending this logic to its limits, maximum flexibility might be achieved by placing as much as possible under the operations manual and as little as possible in the franchise agreement. However, there are practical and legal limits to this exercise. The far ends of the spectrum are easily discerned and hardly subject to debate. Fundamental rights or obligations of the franchisee, such as the royalty rate or the license to use the franchisor's trademark, could hardly be placed in the operations



manual. The bargain would be ephemeral if the franchisor could unilaterally change such fundamental rights or obligations by revising its operations manual. At the other end of the spectrum, details such as the precise temperature for baking bread or the procedures for laundering hotel linens quite obviously belong in the operations manual.

The difficulties lie in discerning the appropriate placement of items that fall in the gray area between these extremes. There is no precise border or clearly defined decision rule. However, two legal considerations may be instructive, if only by illustration: the implied covenant of good faith and fair dealing; and state trade practices statutes.

### 1. The Implied Covenant

Section 205 of the Restatement (Second) of Contracts, which has been adopted or followed in most states, provides that: "[e]very contract imposes upon each party a duty of good faith and fair dealing in its performance and its execution." The effect of this covenant in the franchise context is succinctly summarized in *Dayan v. McDonald's Corp.*, 466 N.E.2d 958 (Ill. Ct. App. 1984):

[T]he doctrine of good faith performance imposes a limitation on the exercise of discretion vested in one of the parties to a contract...a party vested with contractual discretion must exercise that discretion reasonably and with proper motive, and may not do so arbitrarily, capriciously, or in a manner inconsistent with the reasonable expectations of the parties.

Thus, even though the franchise agreement may permit the franchisor to revise or amend its operations manual or policies in its discretion, that discretion must be exercised reasonably. However, the implied covenant generally operates only where the contract grants one party the right to exercise its discretion; it generally cannot be invoked to override express contractual provisions. See, e.g., *Bonfield v. AAMCO Transmissions*, 708 F. Supp. 867 (ND Ill. 1989).

In *Great Clips, Inc. v. Levine*, Bus. Franchise Guide (CCH) ¶9933 (D. Minn. 1991), the franchise agreement required that the franchisee "operate its Great Clips shop in compliance with the Great Clips rules, regulations, instructions and standards in the Policy and Procedures Manual" and that "Great Clips may revise or add to said Manual at any time in its discretion...." Great Clips issued an operations manual update that required franchisees to adhere to "even dollar" pricing (e.g. \$8.00 or \$9.00 but not \$8.50 or \$8.95), though other prices could be charged in connection with special offers or special event discounts. The update also prohibited special category pricing, such as special rates for children or senior citizens.

The franchisee asserted that the franchisor's pricing policies breached the implied covenant of good faith and fair dealing because no pricing policies were in effect at the time the franchise agreement was signed and none were then contemplated. The



court disagreed. Because the franchisee was free to charge whatever prices it chose, as discounts, special event prices and with coupons, the requirement that the standard, undiscounted price be a single even dollar amount did not breach the implied covenant.

In the *Bonfield* case, the franchisor entered into stipulated judgments with the Attorneys General of several states in order to resolve certain consumer complaints. The franchisor then changed its policies and procedures in order to comply with the stipulated judgments. The plaintiff franchisee alleged that these policy changes (which added to the franchisees' warranty obligations to customers) so impaired the franchisees' competitive position as to make it impossible for franchisees to be successful. Although the franchise agreement gave the franchisor the right to change its policies applicable to franchisees, the franchisee's claim survived a summary judgment motion. The court stated that "even if the express terms of the Agreement permitted AAMCO to alter its policies, it could not change them arbitrarily."

In *Amos v. Union Oil Co.*, 663 F. Supp. 1027 (D. Ore. 1987), the franchisor's sudden lowering of the octane of its unleaded gasoline, without lowering the wholesale price to dealers, and discontinuance of a popular premium gasoline were found to breach the implied covenant. There was evidence that the franchisor recognized, but ignored, the risk of revenue loss from lowering the octane of its product without commensurate competitive pricing. Also of note, the court observed that under Oregon law, a covenant of good faith and fair dealing is implied as a condition in contracts "even if the good faith limitation must overcome an express provision...."

The issue in *Carlock v. Pillsbury Co.*, 719 F. Supp. 791 (D. Minn. 1989) was the air content of ice cream. Air is whipped into ice cream to give it volume. The less air, the denser and richer the ice cream and the higher the perceived quality. Here, the franchisor allegedly increased the air content of bulk ice cream, which was the type sold by franchisees from their outlets, versus pre-packaged pints which the franchisor sold through other retail outlets such as supermarkets. The franchisee's claim that this lowering of the quality of bulk ice cream breached the implied covenant survived the franchisor's motion for summary judgment.

## 2. State Trade Practices Statutes

Many states have statutes prohibiting deceptive trade practices, akin to the Federal Trade Commission Act at the federal level. In some states, the statute is part of a franchise-specific statute or specifically applicable to franchise practices. These statutes can limit the franchisor's ability to change its policies or systems on a discretionary basis.

In *Wright-Moore Corp. v. Ricoh Corp.*, 794 F. Supp. 844 (N.D. Ind. 1991), a copier distributorship agreement provided that Ricoh could "change its prices and terms of sale of the products at any time without prior notice to the distributor." Ricoh issued a letter to the distributor giving the distributor an option to purchase additional equipment at previously offered terms of 15% down and six months to pay the balance. However,

when the distributor tried to exercise the option, Ricoh refused the terms and insisted on payment in cash in advance. The court rejected the distributor's claim that Ricoh's unilateral change of the credit terms violated the Indiana Deceptive Franchise Practices Act, which provides, in relevant part, that it is unlawful for a franchise contract to allow "substantial modification of the franchise agreement by the franchisor without the consent in writing of the franchisee." The court concluded that the change in credit terms was not a substantial modification of the distributorship agreement because the distributor did not show any harm, loss or adverse effect on its business as a result of the change.

A gasoline franchisor's imposition of a discount-for-cash program was found not to "substantially change the competitive circumstances of a dealership" in violation of the Wisconsin Fair Dealership Law in *Remus v. Amoco Oil Co.*, 794 F.2d 1238 (7<sup>th</sup> Cir. 1986). The same result was reached under the Indiana Deceptive Franchise Practices Act in *Montgomery v. Amoco Oil Co.*, 804 F.2d 1000 (7<sup>th</sup> Cir. 1986).

However, in *Tiesling v. White Hen Pantry*, 361 N.W.2d 311 (Wis. App. 1984), the court concluded, in denial of the franchisor's summary judgment motion, that the franchisor's unilateral imposition of a requirement that franchisees operate 24 hours per day might have violated the Wisconsin Fair Dealership Law. Material issues of fact existed as to whether the requirement was "reasonable, essential, and nondiscriminatory," thus precluding summary judgment that the franchisor's termination of the franchise agreement based on failure to comply with the new operating hours was proper under the statute.

### 3. Actual Conflict with the Franchise Agreement.

When a provision of the operations manual contradicts or conflicts with the franchise agreement, courts will generally favor and enforce the franchise agreement. While this may seem an obvious rule of construction, franchisors have been tripped up by it, as illustrated by the following cases.

The franchise agreement at issue in *Promus Hotels, Inc. v. Inn on Robinwood, Inc.*, Bus. Franchise Guide (CCH) ¶1257 (Tenn. Ch. Ct. 2003) provided, in relevant part: "Licensee is an independent contractor. Neither party is a legal representative or has the power to obligate (or has the right to direct or supervise the daily affairs of) the other part for any purpose whatsoever." This is a common provision in franchise agreements, inserted primarily to ward off vicarious liability (franchisor liability for act or omissions of its franchisee towards third parties, discussed further in a later section of this paper). The franchise agreement also provided that the franchisee "is responsible for and has the right to control all claims relating to the operation of the hotel."

The franchisor implemented a "100% satisfaction" guarantee program, under which any unsatisfied guest could complain to Promus directly and Promus would refer the matter to the subject franchisee. If still not resolved to the guest's satisfaction, the Promus operations manual provided that Promus, the franchisor, "assumes

responsibility and resolves the complaint to the guest's satisfaction." The franchisee was then charged an intervention fee and the cost of any refunds or free lodging vouchers issued to the unhappy guest. The court concluded that the guarantee program conflicted with the plain meaning of the franchise agreement, as it permitted the franchisor to: intervene in the "daily affairs" of the hotel; take control and responsibility for "claims relating to the operation of the hotel;" and obligate the franchisee to make refunds or other financial commitments. Thus, the court granted the franchisee's summary judgment motion that the franchisee was not obligated to participate in the guarantee program.

In *BJM & Assocs. v. Norrell Services, Inc.*, 855 F. Supp. 1481 (E.D. Ky. 1994), aff'd 68 F.3d 474 (6<sup>th</sup> Cir. 1995), the franchise agreement provided, in relevant part, that the franchisor "agrees to provide direct mail advertising for prospective customers and to pay for at least four (4) mailings per year to Licensee's mailing list as maintained by Norrell." During the term of the franchise agreement, the franchisor made a strategic decision to terminate its direct mail program and shift its advertising focus to print and national radio advertising. Later, the franchisor switched to a "franchisee-controlled marketing program," which had the effect of shifting the cost of direct mail advertising to the franchisee. In response to the franchisee's complaint that this shift breached the franchise agreement, the franchisor contended that its efforts nevertheless "substantially complied" with the franchise agreement because it provided print and national radio advertising, and later provided franchisees with a "Marketing Tool Box," a direct mail kit that enabled franchisees to conduct their own direct mail campaign, albeit with the cost of printing, preparing, mailing and monitoring being borne by the franchisee.

The court was not persuaded by the franchisor's "substantial compliance" argument. The plain text of the franchise agreement obligated the franchisor to provide, at its own expense, at least four direct mail advertising mailings. The franchisor's failure to do so constituted a material breach of the franchise agreement.

#### 4. A Cautionary Tale About Incorporation

As discussed previously, the requirement that the franchisee observe the policies and procedures set forth in the operations manual may be drafted into the franchise agreement in different ways. One method is to incorporate the operations manual into the franchise agreement by reference, with text such as "the operations manual is incorporated herein as if fully set forth herein." This approach was even endorsed and recommended by the authors of the written materials for a previous session of this Symposium. See Koski, Mills and Zucco, *The Operations Manual*, International Franchise Association 36<sup>th</sup> Annual Legal Symposium, Tab 14 (2003) at p. 12.

The authors do not wish to dispute the conclusions of the prior paper, which are well-reasoned and succinctly articulated. However, incorporation has its potential dark side as well. Full incorporation opens the door for courts to consider the operations manual as imposing duties and obligations on the franchisor, as well as the franchisee.



For example, in *Carlock, supra*, the franchisor's operations manual, denominated "shoppe manual" in the franchisor's system, was incorporated into the franchise agreement "with the same force and effects as if fully set forth herein." The ice cream usage factors (which were directly affected by the air content of the ice cream, which in turn had been unilaterally increased by the franchisor) were included in the shoppe manual. The court had no problem concluding that the ice cream usage factors, and by extension the air content, could have been a binding contractual term, which the franchisor could have breached by unilaterally changing the air content. The issue arose in the context of a summary judgment motion, so the ultimate conclusion is not clear, but the court found that the franchisees had "presented sufficient evidence to survive [the franchisor's] summary judgment [motion] on their claim that the franchise agreement was breached by the dilution of the bulk ice cream."

## 5. Defining the Operations Manual

A key to the flexibility that the franchisor seeks to achieve lies in clearly and precisely defining in the franchise agreement what constitutes the operations manual or the "Manual" that franchisees are obligated to follow. The operations manual may contain "best practices" or other items that are merely advisory rather than mandatory system standards. Also, the franchisor will want to change or supplement the operations manual from time to time as the franchisor's system evolves, necessarily adapts to changing market conditions or competitive pressures or simply further develops or improves its know-how. Convenience or urgency may stimulate the franchisor to issues changes via letters, memos or other written directives, rather than formal changes to a particular book or set of books.

If the franchise agreement defines the operations manual to include "all written directives, policies and procedures" or uses a definition of similar import, then non-essential policies and procedures may be converted into contractual obligations. See, e.g., *Carlock, supra*. In a similar vein, if the franchise agreement permits the franchisor to update the operations manual by a variety of means, then other materials taking the same form (letters, memoranda, etc.) that are not intended to be binding may be argued to be part of the operations manual and thus a binding contractual commitment on the part of the franchisor. Typically, these arguments are not successful (see, e.g., *Talamantez v. McDonald's Corp.*, Bus. Franchise Guide (CCH) ¶11,369 (D. Ariz. 1997) and *Payne v. McDonald's Corp.*, 957 F. Supp. 749 (D. Md. 1997), but the better practice would seem to be to draft the franchise agreement to prevent germination of this type of conflict. Significant considerations include:

- Clearly and precisely define what constitutes the operations manual. The definition should be broad enough to cover all standards, specifications and policies that the franchisor considers mandatory for the system and may wish to enforce as a contractual obligation.
- If necessary, clearly and precisely define what is *not* included in the



operations manual, e.g. management policies or franchisee incentives of the franchisor that are intended to be optional or that the franchisor may wish to withdraw or discontinue at its discretion; best practices or suggestions issued in writing that, if mandatory, may open the franchisor to vicarious liability for acts or omissions of the franchisee.

- Clearly and precisely define how changes or supplements to the operations manual are issued. The Manual may be a loose-leaf system to which the franchisor issues formal updates. If emergencies or other time pressures may necessitate issuance of changes by letter or memo, define the procedure for issuance of an operations manual change by this means (perhaps a particular page header or cover sheet).

## 6 Remarkable Anecdotes

Research for this paper uncovered a couple of unusual provisions in operations manuals. In each case, the provision was not the issue in the case so the franchisor's rationale or justification is not clear. In the authors' view, these provisions are curious.

In *Universal Restoration Services v. Paul W. Davis Systems, Inc.*, Bus. Franchise Guide (CCH) ¶12,333 (N.D. Ill. 2002), the franchise agreement provided that "any controversy or claim arising out of or relating to this contract or the breach thereof, shall be settled by arbitration in accordance with the arbitration procedures set forth in Booklet Eight of the operations manual." The scope of the procedures contained in the operations manual is not the central issue in the case and thus is not discussed. Still, it seems unusual that arbitration procedures, which presumably could include forum, venue, number of arbitrators and selection procedures, would be included in the operations manual, where the franchisor likely has the right to make unilateral changes.

In *Scales v. Sonic Industries*, 887 F. Supp. 1435 (E.D. Okla. 1995), the franchisor's operations manual designated the franchisor as the final arbiter of franchisees' employment relations matters and established an appeals procedure for franchisee employees dissatisfied with the resolution of their complaints, up to an including written appeal to the President of Sonic Industries (the franchisor). Again, the operations manual provision (as between the franchisor and the franchisee) was not the central issue in the case, so the franchisor's rationale for the provision is not discussed. The issue was whether the appeals process setting up the franchisor as the final arbiter of franchisee employment matters made the franchisor liable as the employer under federal employment discrimination statutes. It is curious that the franchisor would have any interest in getting involved in its franchisees employment matters. Although the franchisor ultimately prevailed in this case, this involvement seems to invite claims and controversies of this type and other vicarious liability claims.

## **B. Confidentiality**

Confidentiality concerns often weigh in favor of shifting detailed policies, procedures, standards and specifications to the operations manual. The Franchise Agreement is typically not a confidential document. In many of the states that require registration of the franchise offering, the registration filings are public documents, open to inspection and even copying by the general public. Also, the franchise agreement is a required exhibit to the franchise offering circular ("UFOC") and UFOC's inevitably wind up in the hands of prospects who ultimately do not pan out and do not enter into a contract with the franchisor.

Conversely, the operations manual typically constitutes confidential information and maintenance of its confidential nature may be enforced by contract. The operations manual may even constitute a trade secret of the franchisor. *See, e.g., Quizno's Corp. v. Kampendahl*, Bus. Franchise Guide (CCH) ¶12,335 (N.D. Ill. 2002); *Gold Messenger, Inc. v. McGuay*, 937 P.2d 907 (Colo. App. 1997). The North American Securities Administrators Association (NASAA), in the guidelines for preparation of the UFOC, recognizes the distinction by requiring disclosure of only the table of contents of the franchisor's operations manual, *see* Bus. Franchise Guide (CCH) ¶5763, while the franchise agreement must be disclosed in full. *Id.* at ¶5774.

Detailed specifications, standards, procedures or policies may be integral to the franchisor's system and their confidentiality may be a vital business interest. Thus, the operations manual may function as a repository of confidential information relating to operation under the franchisor's system, yet also constitute standards that are enforceable by contract when the franchise agreement refers to the operations manual and requires compliance with its provisions.

## **C. Control Issues.**

### **1. Vicarious Liability.**

Franchisor liability to third parties for injuries or damages arising from acts or omissions of the franchisee or from events or circumstances occurring or existing in connection with the franchisee's operation of the franchised business (vicarious liability) is typically asserted under the theory that the franchisor exerted (or had the right to exert) control over the aspect of the franchise operation which caused the injury or damages or in which the injury or damages occurred. Thus, the argument goes, the franchisee is a mere agent of the franchisor and the franchisor is ultimately liable for the alleged injury or damages.

Courts may read the franchise agreement and the operations manual together to determine whether the requisite control, or right to control, existed (or may have existed). Where the injury is caused (or alleged to be caused) by the franchisee's adherence to mandatory specifications established by the franchisor, the franchisor is likely to be exposed to vicarious liability. Also, vicarious liability exposure may be found



where the franchisor has assumed control, or the right to control, the specific activity or aspect of the franchised business that is the subject of the alleged injury.

Summarized below are cases both supporting a finding of vicarious liability and denying or militating against franchisor vicarious liability. These are intended to be illustrative only and certainly not an exhaustive list of published cases on this issue. Readers should also note that in many of the cases the court's decision is a denial of summary judgment, so the ultimate outcome on the vicarious liability is not determined in the published opinion.

The case of *Pizza K. v. Santagata*, 547 S.E.2d 405 (Ga. Ct. App. 2001) addresses the vicarious liability issue but is also remarkable for revelation of a curious aspect of the franchise agreement that was not at issue in the case. The central issue was whether the franchisor could be held liable for injuries sustained by a motorist involved in an accident with a delivery driver employed by a franchisee. Although the trial court had denied the franchisor's summary judgment motion, the appellate court reversed. The franchise agreement required the franchisee to operate its business in "in accordance with the standards, specifications and procedures set forth" in the operations manual and provided for periodic inspections by the franchisor to determine compliance with the franchise agreement and the operations manual, but neither document provided for the franchisor's supervisory control over persons hired as delivery drivers or even guidelines for the hiring or firing of drivers. The court concluded that the compliance inspections and requirements to adhere to the operations manual did not amount day-to-day supervisory control over the franchisee. Thus, the franchisee was not the agent of the franchisor and the franchisor could not be vicariously liable.

The opinion also notes that the franchise agreement provided that the franchisor had "the right to require the immediate termination of any employee who causes the facility to fail an inspection." This provision arguably gives the franchisor significant control over the franchisee's employment decisions and consequently exposure to vicarious liability for employment claims by the franchisee's employees. In the authors' view, a better practice is to reserve the right to require retraining of employees whose performance causes the franchisee to breach the franchisor's standards, but stop short of a right to require termination of a particular employee. If breach of the standard (or, in this case, failure of an inspection) is a breach or default under the franchise agreement, the franchisor has the ability to default the franchisee and require cure of the breach or default. The means to effect the cure can be left to the franchisee. Thus, if the best or only means to cure is to terminate an employee, it would be the franchisee's decision and only the franchisee should be exposed to employment-related claims arising therefrom.

The franchisor's liability for violations of the Americans with Disabilities Act (ADA) was at issue in *United States v. Days Inns*, Bus. Franchise Guide (CCH) ¶11,504 (E.D. Ky. 1998). The ADA prohibits "failure to design and construct facilities...that are readily accessible to and usable by individuals with disabilities...." Here, the government contended that a newly constructed franchised Days Inn hotel was not compliant with

the ADA and sued the franchisee and the franchisor, among others, for the violations. The government's case against the franchisor rested on two theories: that the franchisor was the "operator" of the hotel for purposes of the ADA; and the usual vicarious liability theory, that the franchisor controlled the day-to-day operations of the hotel and thus the franchisee was merely the agent of the franchisor. The government's case failed under both theories.

The franchise agreement provided that the franchisor's review and approval of the plans for the hotel were solely for the purpose of determining compliance with the franchisor's system standards and specifically stated that the franchisee was responsible for constructing and operating the hotel in compliance with all legal requirements. Thus, the franchisor did not have control over the construction of the hotel with respect to ADA requirements and could not be considered an "operator" of the hotel for purposes of the ADA.

In connection with the control/agency theory, the court reviewed the franchisor's operations manual. The manual contained detailed specifications and standards for operation of the hotel, as fine as: the number and locations of pictures, towel racks, ashtrays and other similar furnishings; grooming standards for employees; required services, such as complimentary coffee; and hours of operation of the front desk. The franchisor also provided training to the franchisee's employees, covering items such as guest relations services, setting room rates and motivating and managing hotel personnel. The court concluded that, although these detailed specifications and standards certainly gave the franchisor "influence" over the way the hotel operates, they did not amount to "control" in the ordinary sense. In the court's view, these mechanisms were aimed at improving the quality of the experience of the hotel guest, thus protecting the "Days Inn" trademark, as the quality of service provided by the franchisee directly reflects on the franchisor. Regarding the ADA, *see also Dahlberg v. Avis Rent A Car Systems, Inc.*, 92 F. Supp. 2d 1091 (D. Colo. 2000) (franchisor not "operator" for purposes of the ADA of franchised location at Los Angeles airport).

Franchisee employees sued the franchisor, as well as their franchisee employer, for various employment claims in *Miller v. D.Z. Zee's, Inc.* 31 F. Supp. 2d 792 (D. Ore. 1998). In denying the franchisor's motion for summary judgment, the court asserted that the franchisor's operations manual gave the franchisor "the right to control their franchisees in the precise parts of the franchisee's business that allegedly resulted in plaintiffs' injuries - training and discipline of employees."

However, the potential exposure to vicarious liability may not even be the most troubling aspect of the *Miller* opinion for franchisors. The *Miller* court also stated that the franchisee's employees could assert claims directly against the franchisor for "negligent training and negligent enforcement of the Franchise operations manual policies." Thus, if the franchisor undertakes training of the franchisee in matters such as preventing/avoiding sexual harassment or discrimination in employment, as many franchisors do, then the franchisor may be saddled with a duty of care, to *potentially affected third parties*, in the conduct of the training. If the operations manual mandates



compliance with non-discrimination policies, then likewise a duty may arise, to *third parties*, to enforce the standards with reasonable care and diligence. Fortunately (at least from a franchisor perspective), few other courts have adopted this view in published opinions.

In *Helmchen v. White Hen Pantry, Inc.*, 685 N.E.2d 180 (Ind. App. 1997), the franchisor was accused of negligently failing to provide adequate security at a franchise location, leading to the death of a franchisee employee who was murdered during an attempted robbery at the location. The franchise agreement provided that failure to follow any mandatory procedures in the operations manual constituted cause for termination of the franchise agreement. The operations manual and certain correspondence from the franchisor to its franchisees addressed robberies, but provided only “useful techniques when confronted with an armed robbery,” not “mandatory security measures.” According to the court, the franchisor was merely sharing useful knowledge gained from its own years of experience in operating convenience stores. For the type of control giving rise to a duty to third parties, the court required “more than the mere making of suggestions or recommendations.” Thus, the court affirmed the trial court’s grant of summary judgment in favor of the franchisor.

The claim of a Burger King customer injured by spilled hot coffee was able to survive the franchisor’s summary judgment motion in *Nadel v. Burger King Corp.*, 695 N.E.2d 1185 (Ohio App. 1997). Although the franchisor had won summary judgment in the trial court, the appellate court reversed, concluding that the franchisor’s control over details such as the temperature at which coffee must be brewed meant that the franchisee “could be considered an agent of [the franchisor] with respect to those details.”

In *Scales, supra*, the franchisor’s operations manual provided an appeal process for franchisee employees, including a direct appeal to the President of the franchisor. The court concluded that this appeal process did not give the franchisor sufficient control over the franchisee’s employment relations to make the franchisor the “employer” of the franchisee’s employees for purposes of liability under federal civil rights statutes. The court followed an “integrated enterprise” test developed by the Tenth Circuit, which considers: (1) interrelation of operations; (2) centralized control of labor relations; (3) common management; and (4) common ownership or financial control. In the present case, the court found that: (1) the franchisee owned and operated the restaurant where the plaintiff was employed; (2) the franchisor did not direct the plaintiff’s work performance and did not participate in the franchisee’s employment-related decisions; (3) the franchisor did not pay the plaintiff or provide any employment benefits to the plaintiff; and (4) as between the franchisor and franchisee, there was no common ownership, financial control or common or joint management. Thus, the franchisor could not be the “employer” of the franchisee’s employees for purposes of federal employment statutes.

A franchisee employee who was criminally assaulted sued the franchisor for failure to provide adequate security in *Hoffnagle v. McDonald’s Corp.*, 522 N.W.2d 808

(Iowa 1994). The franchise agreement required that the franchisee adopt and use the franchisor's operations manual, and provided that the franchisor would provide training to the franchisee and its managerial employees. A number of interrelated issues are addressed in the opinion, as McDonald's typically owns the property where its franchises are located and leases the location to the franchisee. On vicarious liability, the court concluded that the required adoption of the franchisor's operations manual, the offering of training, and retaining the right to inspect the franchisee's operations constituted "no more than the authority to insure the uniformity and standardization of products and services offered" at a McDonald's restaurant. Such authority did not amount to control of the day-to-day operations of the restaurant so as to give rise to a duty on the part of the franchisor to ensure the safety and security of the franchisee's employees.

Compare the foregoing case to *Martin v. McDonald's Corp.*, 572 N.E.2d 1073 (Ill. App. 1991). In *Martin*, an employee of a McDonald's franchisee was murdered during an armed robbery and two other employees were criminally assaulted. Here, the court concluded that the franchisor had voluntarily assumed a duty to provide security and protection to its franchisee's employees. The franchisor had created a branch of its corporation specifically to deal with security problems and had prepared a detailed security manual. Franchisor personnel visited the franchisee's locations, advised the franchisee of security issues, communicated the franchisor's security policies and undertook to follow-up with the franchisee to ensure that security issues had been corrected and that the franchisor's "recommended" security procedures were "followed." In view of these factors, the court concluded that the trial court had correctly determined that the franchisor had "assumed a duty to provide security and protection" to the franchisee's employees.

*Parker v. Domino's Pizza, Inc.*, 629 So. 2d 1026 (Fla. Dist. Ct. App. 1993) is perhaps the most famous vicarious liability case, as a fair portion of the general public recognizes the case from the publicity that surrounded it. In this case, the plaintiffs were injured in an auto accident caused by a delivery driver of a franchised Domino's Pizza location. The franchise agreement provided that the franchisee was required to abide by the Domino's operations manual. The manual provided that "a Domino's pizza is delivered within 30 minutes." Considering this and other detailed provisions of the operations manual, which the court dubbed "a veritable bible for overseeing a Domino's operation," the court held that whether Domino's retained the right to control the methods of operation of the franchisee to an extent to render the franchisor liable for negligent or reckless conduct by the franchisee's employees presented an issue of fact that precluded summary judgment for the franchisor on the issue of vicarious liability. The case is well known by the general public because the franchisor ultimately paid a multi-million dollar damage claim, which led to the demise of its system's guarantee of delivery within 30 minutes or the pizza is free of charge.

In *Hilton v. Holiday Inns, Inc.*, Bus. Franchise Guide (CCH) ¶9663 (S.D.N.Y. 1990), the plaintiff sued the franchisor after being injured in a car accident while being transported by franchisee hotel manager to an airport shuttle. A malfunction in the hotel

manager's vehicle, in which the plaintiff was riding, was the apparent cause of the accident. The franchise agreement required the franchisee to comply with the franchisor's Standards Manual and Rules of Operation. The manual contained detailed standards and provided that "personnel, building, grounds, furnishings, fixtures, decor, equipment, signs, *vehicles*, utensils, linens, supplies, foodstuffs, china, glass, silver, printed matter and any other element" affecting hotel guests, directly or indirectly, "*must be maintained at all times in accordance with the high standards of quality and appearance associated with Holiday Inns*," including "cleanliness, service level, *safety*, wear, adequacy of supply, working order and coordination of color schemes and designs." (emphasis added by court). In view of the references specifically to vehicles and safety and working order standards, the court found that the franchisor exercised "a certain degree of control" over the franchisee and denied the franchisor's motion for summary judgment on the issue of vicarious liability.

## 2. SBA Guidelines

Many franchisees seek financing via loans backed by the Small Business Administration (SBA). The SBA will review the franchise agreement to determine whether the franchisor has "excessive control" over the franchisee, such that the franchisee is the mere agent or servant of the franchisor. The rationale is that if the franchisor and the franchisee are in substance one integrated business, even if independent in form, then the franchisee is not really a "small" business and does not qualify for SBA financing. The SBA does not review the franchisor's operations manual. Thus, to the extent that detailed operations provisions can be shifted to the operations manual, the less the appearance of "excessive control" in the franchise agreement.

Also, review of the franchise agreement by different SBA offices or personnel can result in inconsistent findings. The SBA, in association with FRANDATA Corp., maintains a registry of franchises whose agreements have been vetted by the SBA for control issues. Once a franchisor's franchise offering is listed in the registry, individual SBA offices do not review the franchise agreement. Although there is some cost to getting the franchise agreement reviewed for placement on the registry, for franchisors interested in boosting their franchisees' chances of securing affordable financing, the registry provides a shortcut through a substantial amount of potential red tape.

### **D. Default and Cure Provisions**

The approach to default and cure provisions in the franchise agreement may go hand-in-hand with the flexibility issues discussed above. Typically, the franchisor has a set of standards, specifications and procedures, set forth in the operations manual, coupled with a provision in the franchise agreement that the franchisee is required to adhere to the operations manual. However, the operations manual is often very detailed (down to number and placement of ashtrays in a hotel room. See, e.g., *Days Inns, supra*). If every failure to meet any specification or standard in the operations manual constitutes a breach of the franchise agreement, which technically it does in many cases, then few franchisees are not in breach. However, the franchisor generally



has no desire to terminate the franchise agreement or sue the franchisee for breach if one ashtray is misplaced, even if the franchisor is keenly interested in ensuring that all franchisees adhere to the operations manual in order to maintain standardization and uphold the quality image of the system and the franchisor's trademarks.

Franchisors can address this conundrum by creating different classes of breaches or defaults under the franchise agreement and integrating the operations manual in the identification and remedy of operational defaults. The following example is illustrative only, as there can be no one-size-fits-all approach to this issue. Different franchise systems may have unique characteristics that require tailored approaches.

1. Immediate and Imminent Impairment of Goodwill.

This category may include breaches of covenants, such as disclosure of the franchisor's trade secrets or gross or egregious operational defaults that may cause immediate harm to the goodwill of the franchisor's system, such as threats to public health or safety or willful violation of laws. In these cases, the franchise agreement might provide for a very short cure period, or even immediate cure or closure of the franchise while the cure is effected. In some cases, immediate termination without a cure period may be warranted.

2. Monetary Defaults.

Failure to pay liquidated monetary amounts might be subject to a relatively short cure period before termination of the franchise agreement is available as a remedy. Typically, this involves amounts that the franchisee has contractually agreed to pay and the means to cure is certain.

3. System Standards.

Addressing breaches of standards often requires more finesse. As previously mentioned, the franchisor will not want to terminate the franchise agreement for one minor breach, such as a misplaced ashtray, but neither will the franchisor want to tolerate continued or accumulated breaches that may erode the goodwill of the franchisor's system if not abated. A typical method is to develop a scoring system, whereby the franchisor's representative inspect the franchisee's operations periodically and score the franchisee's compliance with the operations manual on a predetermined basis. The scoring system can be set forth in the operations manual, so that the franchisor has the flexibility to change and adapt the details of the scoring system. The franchisor can assign a minimum score for a "passing" grade (which can also be revised as the emphasis of the scoring may be changed). Using the hotel example, a misplaced ashtray might be a one point deduction, where a guest relations issue or reservation error might be 5 or 10 points.

The scoring system also has the advantage of allowing compliance to be quantified and more objective than a purely qualitative review.



The franchise agreement or operations manual may provide for a cure period to correct a failing grade, or that a certain number of failing grades in a specified period constitutes a default under the franchise agreement, which must be cured within a stated period. Thus, material compliance with the franchise agreement and the operations manual may be enforced without having to resort to termination or a lawsuit for every misplaced ashtray.

#### 4. State Statutes.

Whatever the system adopted by the franchisor, care must be taken not to run afoul of state statutes, which sometimes require minimum cure periods or impose other obligations upon the franchisor. For example, the New Jersey Franchise Practices Act, (N.J. Rev. Stat. 56:10-5) requires a minimum of 60 days notice of termination except in certain limited circumstances. The Wisconsin Fair Dealership Law (Wis. Stat. Ch. 135, §135.04) requires a minimum 90 day notice and minimum 60 day cure period prior to termination, except for nonpayment of monetary sums due, for which the cure period may be shortened to 10 days. Similarly, the Minnesota Franchises Act (Minn. Stat. Ch. 80C, §14) requires a minimum 90 day notice and 60 day cure period, except for certain defaults, such as abandonment of the franchise, for which immediate termination is permitted and defaults that "materially impair[] the goodwill associated with the franchisor's trade name, trademark, service mark, logotype or other commercial symbol," for which the cure period may be as short as 24 hours.

Consequently, in drafting the default and cure provisions, the franchisor may need to consider the state in which the franchise will be located (or in some cases, other factors that make a particular state's law applicable) and possibly make corresponding adjustments to the franchise agreement or default & cure policies in the operations manual. Also, a number of states have laws requiring the franchisor, at least in some circumstances, to repurchase inventory or otherwise compensate the franchisee upon termination of the franchise. See, e.g. Conn. Gen. Stat. Ch. Title 42 739, § 42-133f; Iowa Code, Title XIII, §523H.11; Wis. Stat. Ch. 135, §135.045. The franchisor may also want to consider these statutes in crafting its default and termination provisions.

#### **E. Incorporation of Franchisee Improvements**

Franchisees, who are often immersed in the day-to-day operation of the franchisor's system, may sometimes conceive of improvements or enhancements to the system or useful procedures or methods of operations that may increase the efficiency or profitability of operations under the system. Absent contractual agreement, ownership of and the right to exploit such enhancements or improvements may become an issue of contention. On the one hand, it may be the franchisee's own ingenuity and efforts that produced the enhancement or improvement to the system. On the other, the franchisor has likely trained the franchisee in the operation of the system, which the franchisor has spent significant time, effort and money to establish and develop, even imparting trade secrets and other confidential information and "know-how" to the

franchisee. Thus, the franchisee would not be in a position to create the improvement without the benefit of the franchise granted by the franchisor.

Typically, the franchise agreement provides that the franchisor has the right to incorporate into the system, for use by the franchisor and other franchisees, any enhancement or improvement developed by the franchisee, without royalty or other payment or obligation to the franchisee. This is usually balanced by a franchise agreement provision in which the franchisor agrees to continue efforts to improve and enhance the system and impart all enhancements or improvements to the franchisee, without payment of any additional fee or royalty.

## **F. Other Potential Considerations**

### **1. Inter-franchisee matters**

Most franchise agreements contain at least some provisions that affect all franchisees, not just the particular franchisee or location that is the subject of the individual franchise agreement. For example, many franchise agreements provide that all franchisees must contribute to a national advertising fund or advertising cooperative. If the franchisor desires to retain the flexibility to change or revise such requirements, it may be advisable to shift as much of the details as reasonably possible to the operations manual, in order to avoid conflicting contractual provisions.

Consider also situations that may affect inter-franchisee relations but not the franchisor directly. For example, the franchise agreement may require that franchisees in an identified market form and contribute to an advertising cooperative, enabling the franchisees in the market to purchase local radio and TV advertising that otherwise would be impractical. Thus, all franchisees in the market are interested in the other franchisees' compliance with the requirement to contribute to the cooperative. A franchisee who refuses to contribute or is delinquent in its contributions may receive the benefit of the local broadcast advertising without bearing any of the cost.

However, if the only remedy available to the franchisor is default and ultimately termination of the franchise agreement, then the franchisor may be in an uncomfortable position, having to either terminate an otherwise healthy and economically productive franchise or alienate the other franchisees in the market. Providing dispute resolution or remedies short of termination in the operations manual may help avert some of these difficult problems.

### **2. Sales vs. Operations Dynamic**

The sales and operations business units of the franchisor's organization may sometimes advance competing goals in the drafting and content of the franchise agreement. From a sales perspective, the shorter the better. Sales personnel often do not want prospective franchisees to be intimidated or put off by the sheer volume of the franchise agreement. Operations, conversely, often wants very specific details included

in the franchise agreement, so that there is no doubt or potential controversy as to the franchisee's obligation with respect to particular points.

The operations manual can be at least a partial solution to this dilemma. The franchise agreement can state, expressly and unequivocally, that adherence to the operations manual is a obligation under the franchise agreement, breach of which constitutes default and grounds for termination, and this can be done in relatively few words. The operations manual, which need not be presented in its entirety to the franchisee until training begins, may be much more voluminous without the same intimidation factor as the franchise agreement. The franchisee expects the operations manual to contain advice and direction in the operation of the franchised business. Thus, comprehensiveness and detail in the coverage of the operations manual may actually be viewed as a source of comfort and assurance by the franchisee, whereas the Franchise Agreement is viewed as restrictive and imposing. There, less is more in the eyes of the typical franchisee.

#### **IV. COMMON PROVISIONS**

Although franchising is a business model that has been adopted in countless industries, there are common themes that run through nearly every franchise agreement. For example, at heart, every franchise agreement involves the grant of a right to use trademarks and a business system. Nearly every franchise agreement contains a specified term during which the franchisor and franchisee will be obligated to each other and which may be extended by renewal. And, practically every franchise agreement makes some provision for the marketing of the system.

In this section, we will identify the portions of a typical franchise agreement that address these issues, as well as other provisions that the authors feel are fundamental to the franchise relationship. Following the discussion of each provision is a sample provision for illustrative purposes. The authors would like to emphasize that each franchise agreement is unique and each provision should be modified to fit the circumstances in which it is used.

##### **A. Grant**

The fundamental starting point in drafting any franchise agreement is determining what rights the franchisee will be granted. Certainly, the franchisee will need a license to use the franchisor's trademark. And, the franchisor's business know-how and techniques for operating the franchised business represent a form of intellectual property that the franchisee must be granted the right to use. But, what limitations will be placed on the franchisee? What protection, if any, will the franchisor provide to the franchisee? Is the license exclusive? If so, what does "exclusive" mean?

In many industries, franchisees are not granted any exclusivity at all. In effect, they are simply granted the right to operate a franchised business at a specific location,



but are not affirmatively granted any territorial rights surrounding that location. Such a grant, however, can be problematic when the franchisor decides to place a new unit in close proximity to an existing unit as was the case in *Scheck v. Burger King Corp.*, F. Supp. 692 (S.D. Fla. 1992). In *Scheck*, Burger King's placement of a new unit about two miles from an existing location was found to be a breach of the franchise agreement's implied covenant of good faith and fair dealing, despite the fact that the franchise agreement did not, by its express terms, limit Burger King's right to place a new unit near the existing unit. Although *Scheck* has either not followed or distinguished by other courts in subsequent cases,<sup>13</sup> it serves as a warning to any franchise agreement drafter who would assume that a right not expressly reserved to the franchisor might be limited by the covenant of good faith and fair dealing.

As a result of *Scheck* it has become standard practice specify in the franchise agreement exactly what types of activities the franchisor reserves the right to engage in. In particular, a franchisor may want to retain the rights to:

- marketing the businesses operating under the system;
- establish franchisor owned units;
- license others to establish units;
- operate competing businesses under other marks;
- acquire, or be acquired by, a competing business;
- sell products or services through alternative channels of distribution; or
- sell products or services at alternative venues.

If the franchisor provides any territorial protection to its franchisees, it may also want to specify which of the rights listed above it reserves within the protected territory.

#### *Sample "Grant" provision*

Franchisor grants to Franchisee the right, and Franchisee undertakes the obligation, upon the terms and conditions set forth in this Agreement: (a) to establish and operate a Franchised Business; and (b) to use the Proprietary Marks and the System solely in connection therewith.

The Franchised Business shall be operated solely at \_\_\_\_\_ (the "Approved Location").  
The Franchised Business may not be relocated without the written approval of Franchisor.

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<sup>13</sup> See, e.g., *Burger King Corp. v. Weaver*, 169 F. 3d 1310 (11<sup>th</sup> Cir. 1999); *Orlando Plaza Suite Hotels, Ltd.-A v. Embassy Suites, Inc.*, Bus. Franchise Guide (CCH) ¶10,457 (M.D. Fla. March 1, 1993).

During the term of this Agreement, provided that Franchisee is in compliance with the terms of this Agreement, Franchisor shall not establish or grant a license to another to establish a Franchised Business within \_\_\_\_\_ (the "Territory"). Franchisee acknowledges and agrees that nothing contained in this Section \_\_\_\_\_ shall prohibit Franchisor from: (a) conducting marketing and promotional activities in the Territory; (b) establishing or operating, or licensing to others the right to establish and operate other businesses under the System and the Proprietary Marks at any location outside of the Territory, regardless of their proximity to the Territory; or (c) selling or distributing, directly or indirectly, or licensing to others the right to sell or distribute, any products including but not limited to the any products under the Proprietary Marks or any marks at or through locations other than Franchised Businesses within or outside the Territory, regardless of proximity to the Approved Location. Franchisor reserves all rights not specifically granted to Franchisee hereunder.

## **B. Term/Renewal**

How long a franchise agreement lasts is typically based, in part, on the length of time a franchisee will need in order to recoup its investment in the franchised business and provide the franchisee an opportunity to earn a reasonable rate of return on that investment. As such, the length of the term of the franchise agreement is a significant sales issue. If the term is too short, fewer prospective franchisees will want to buy the franchise. This reality often creates an incentive for franchisors -- or franchisor salespersons -- to offer agreements with no expiration or with unlimited renewal rights. A franchisee operating under a contract with such a provision may wish to argue that the franchise is perpetual, and in some states that argument may prevail.<sup>14</sup> However, other states have adopted a rule of construction that disfavors perpetual contracts.<sup>15</sup> Because certain state franchise laws limit the franchisor's right to refuse to renew a franchise agreement,<sup>16</sup> a franchise agreement that contains unlimited renewal terms

<sup>14</sup> See, e.g., *W. A. Stratton Constr. Co. v. Butler Manuf. Co.*, 1990 U.S. Dist. LEXIS 19772 (W.D.Va. 1990).

<sup>15</sup> See, e.g., *Preferred Physicians Management Group, Inc. v. Preferred Physicians Mutual Risk Protection Group*, 961 S.W.2d 100 (Mo. App. 1998) and *Betsy-Len Motor Hotel Corp. v. Holiday Inns Co.*, 238 Va. 489 (1989).

<sup>16</sup> See, e.g., Cal. Bus. and Prof. Code §20025; Conn. Gen. Stat. §42-133f; 815 Ill. Comp. Stat. 705/20.

could effectively limit the franchisor's right to not renew the franchise to circumstances under which the franchisee is in material default of the franchise agreement.

As noted in Section II, above, precision is one of a drafter's primary goals. If the term of the franchise agreement (or, lack of a term) creates uncertainty as to the parties rights, the possibility for time consuming litigation is increased. In the authors' view, it is far better to specifically delineate the circumstances under which renewal may occur and identify any limitations on it.

*Sample "Term and Renewal" provision*

This Agreement shall be effective upon its execution by the parties. The term of this Agreement shall be \_\_\_\_\_ (\_\_\_\_) years and shall expire on \_\_\_\_\_, unless sooner terminated pursuant to the terms hereof.

Franchisee may, subject to the following conditions, renew this Agreement for \_\_\_\_\_ (\_\_\_\_) additional consecutive term of \_\_\_\_\_ (\_\_\_\_) years. Franchisor may require satisfaction of any or all of the following conditions prior to such renewal:

Franchisee shall give Franchisor written notice of Franchisee's election to renew not less than \_\_\_\_\_ (\_\_\_\_) months nor more than \_\_\_\_\_ (\_\_\_\_) months prior to the end of the then-current term;

Franchisee shall make or provide for, in a manner satisfactory to Franchisor, such renovation and modernization of the premises of the Franchised Business as Franchisor may require, which may include installation of new equipment and renovation of signs, furnishings, fixtures, and decor to reflect the then-current standards and image of the System;

Franchisee shall not be in default of any provision of this Agreement and Franchisee shall have substantially and consistently complied with all the terms and conditions of this Agreement during its term;

Franchisee shall have satisfied all monetary obligations owed by Franchisee to Franchisor and Franchisee's suppliers, and shall have timely met those obligations throughout the term of this Agreement;

Franchisee shall, at Franchisor's option, execute Franchisor's then-current form of franchise agreement which will supersede this Agreement in all respects. The terms of



the then-current form of franchise agreement may differ in many or all material respects from the terms of this Agreement, including but not limited to differences in the provisions regarding royalty fees, term, Territory, and advertising contributions or obligations; however, Franchisee shall not be required to pay another Initial Franchise Fee;

Franchisee shall execute a general release, in a form prescribed by Franchisor, of any and all claims against Franchisor and its affiliates, and their respective officers, directors, securities holders, agents, and employees;

Franchisee shall comply with Franchisor's then-current qualification and training requirements, at Franchisee's expense; and

Franchisee shall pay to Franchisor a fee of \_\_\_\_\_ (\$\_\_\_\_\_).

### **C. Trademark License**

A license permitting the franchisee to use a trademark is perhaps the most fundamental element of a franchise. One of the central themes of franchising is that consumers associate a specific experience -- quality of goods, customer service, convenience, etc. -- with the trademark used to identify a franchise system. This consumer identification creates a ready market for new franchisees and enables a franchisor to leverage its goodwill in its mark into more rapid expansion than it might otherwise be capable. If the franchisee uses the marks properly, the franchisor benefits from increased revenues from royalties paid by the franchisee and by increased goodwill associated with consumers' experiences in dealing with the franchisee. Franchisees benefit from the brand recognition generated by the system-wide use of the mark.

In order for a trademark to have value, however, it convey a specific message to consumers. If a consumers' experiences with different locations operating under the same mark, they may either recognize that their next experience with other businesses under the same mark will be of uncertain quality or assume that their worst experience was the norm. In either case, they may decide not to patronize the businesses operating under that mark again. It is for this reason that a franchisor's control over the marks used to identify its franchise system is essential for both the franchisor and its franchisees.<sup>17</sup>

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<sup>17</sup> It is also worth noting that the Lanham Act requires the licensor of a trademark to retain control over the mark and to police the products and services offered under it in order to maintain the protections granted by the act. See 15 U.S.C. § 1064

*Sample "Trademark License" provision*

With respect to Franchisee's use of the Proprietary Marks pursuant to this Agreement, Franchisee agrees that:

Franchisee shall use only the Proprietary Marks designated by Franchisor, and shall use them only in the manner authorized and permitted by Franchisor and any unauthorized use thereof shall constitute an infringement of rights of Franchisor;;

Unless otherwise authorized or required by Franchisor, Franchisee shall operate and advertise the Franchised Business only under the name "\_\_\_\_\_" without prefix or suffix. Franchisee shall not use the Proprietary Marks as part of its corporate or other legal name;

Franchisee shall identify itself (and not the Franchisor) as the owner of the Franchised Business in conjunction with any use of the Proprietary Marks, including, but not limited to, the use thereof on leases, invoices, order forms, receipts, and business stationery, as well as at such other locations as Franchisor may designate in writing;

Franchisee shall not use the Proprietary Marks to incur any obligation or indebtedness on behalf of Franchisor;

Franchisee shall execute any documents deemed necessary or useful by Franchisor to obtain protection for the Proprietary Marks or to maintain their validity and enforceability; and

Franchisee shall promptly notify Franchisor of any suspected unauthorized use of the Proprietary Marks, any challenge to the validity of the Proprietary Marks, or any challenge to Franchisor's ownership of the Proprietary Marks, or any challenge to Franchisor's right to use and to license others to use such Proprietary Marks, or Franchisee's right to use the Proprietary Marks. Franchisee acknowledges that Franchisor has the right to direct and control any administrative proceeding or litigation involving the Proprietary Marks, including any settlement thereof. Franchisor has the right, but not the obligation, to take action against uses by others that may constitute infringement of the Proprietary Marks. Franchisor (and not Franchisee) shall defend Franchisee against any third-party claim, suit, or

demand arising out of Franchisee's use of the Proprietary Marks. If Franchisor determines that Franchisee has used the Proprietary Marks in accordance with this Agreement, the cost of such defense, including the cost of any judgment or settlement, shall be borne by Franchisor. If Franchisor determines that Franchisee has not used the Proprietary Marks in accordance with this Agreement, the cost of such defense, including the cost of any judgment or settlement, shall be borne by Franchisee. In the event of any litigation relating to Franchisee's use of the Proprietary Marks, Franchisee shall execute any and all documents and do such acts as may, in the opinion of Franchisor, be necessary or useful to carry out such defense or prosecution, including, but not limited to, becoming a nominal party to any legal action. Except to the extent that such litigation is the result of Franchisee's use of the Proprietary Marks in a manner inconsistent with the terms of this Agreement, Franchisor agrees to reimburse Franchisee for its out-of-pocket costs in doing such acts.

Franchisee expressly understands and acknowledges that:

The Proprietary Marks are valid and serve to identify the System and those who are authorized to operate under the System;

During the term of this Agreement and after its expiration or termination, Franchisee shall not directly or indirectly contest the validity of Franchisor's ownership of, or Franchisor's right to use and to license others to use, the Proprietary Marks;

Franchisee's use of the Proprietary Marks pursuant to this Agreement does not give Franchisee any ownership interest or other interest in or to the Proprietary Marks;

Any and all goodwill arising from Franchisee's use of the Proprietary Marks shall inure solely and exclusively to the benefit of Franchisor, and upon expiration or termination of this Agreement, no monetary amount shall be attributable to any goodwill associated with Franchisee's use of the System or the Proprietary Marks;

The right and license of the Proprietary Marks granted hereunder to Franchisee is nonexclusive, and Franchisor has and retains the rights, among others: (a) to use the Proprietary Marks itself in connection with selling products and services; (b) to grant other licenses for the Proprietary



Marks; and (c) to develop and establish other systems using the Proprietary Marks, similar proprietary marks, or any other proprietary marks, and to grant licenses thereto without providing any rights therein to Franchisee; and

Franchisor reserves the right to substitute or add different proprietary marks for use in identifying the System and the businesses operating thereunder. Franchisee shall implement promptly any such substitution or addition of new Proprietary Marks. Franchisee shall bear the costs of conforming to Franchisor's new or substituted Proprietary Marks.

#### **D. Manual**

As discussed in Section III of this paper, the franchise agreement must be drafted with an understanding that the details of the operations of a franchised business should be included in an operations manual and that the franchise agreement must provide the franchisor with the flexibility to modify those details as needed.

##### *Sample "Manual" provision*

Franchisee shall operate the Franchised Business in strict accordance with the standards, methods, policies, and procedures specified in the Manual (which may consist of more than one (1) volume, which taken together shall constitute the "Manual"). Franchisee shall receive on loan from Franchisor one (1) copy of the Manual for the term of this Agreement and any renewals, additions, supplements, or extensions thereof.

Franchisor may from time to time revise the contents of the Manual, and Franchisee expressly agrees to comply with each new or changed standard.

Franchisee shall ensure that the Manual is kept current. In the event of any dispute as to the contents of the Manual, the terms of the master copy maintained by Franchisor at Franchisor's home office shall be controlling.

#### **E. Advertising**

Most franchisors make the advertising and promotion of the system a priority in their franchise agreements. This is accomplished in several ways. Often, the franchisee will be required to conduct a minimum amount of advertising on their own behalf. The franchisor will also often take responsibility for marketing and promoting the system as a whole through the operation of an advertising fund that is supported (at

least in part) by fees paid by franchisees. Typically, the franchisor will want to retain tight control of the advertising being used in the system and will create materials to be used by the franchisees in the system or retain the right to approve all forms of advertising the franchisee may wish to use.

The most significant danger, from a franchisor's perspective, arising from these provisions is that a franchisee may claim that the franchisor has misused the funds collected for use in the advertising fund or that the franchisor was a fiduciary with regard to those funds. The primary basis for this concern rests in a 1997 case in which a class of Meineke franchisees obtained a judgment against their franchisor amounting to almost \$591 million.<sup>18</sup> Although much of the judgment was overturned on appeal for procedural reasons,<sup>19</sup> franchise counsel have not ignored the central message of the case -- that the franchisor's rights and obligations in operating the advertising fund must be clearly defined in the franchise agreement.

#### *Sample "Advertising" provision*

Franchisor has established a national advertising fund (the "Fund") which shall be maintained and administered by Franchisor. Franchisee shall contribute \_\_\_\_ percent (\_\_\_%) of its monthly Gross Revenues to this Fund.

Franchisor shall direct all Fund programs, with sole discretion over the concepts, materials, and media used in such programs and the placement and allocation thereof. Franchisee agrees and acknowledges that the Fund is intended to maximize general public recognition, acceptance, and use of the System; and that Franchisor is not obligated, in administering the Fund, to make expenditures for Franchisee, on behalf of Franchisee, or in the Territory which are equivalent or proportionate to Franchisee's contribution, or to ensure that any particular franchisee benefits directly or pro rata from expenditures by the Fund.

The Fund, all contributions to the Fund, and any earnings thereon, shall be used exclusively to meet the costs of maintaining, administering, directing, conducting, and preparing advertising, marketing, public relations, and/or promotional programs and materials, and any other activities

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<sup>18</sup> *Broussard v. Meineke Discount Muffler Shops, Inc.*, No. 3:94CV255-P (W.D.N.C. Mar. 6, 1997).

<sup>19</sup> *Broussard v. Meineke Discount Muffler Shops, Inc.*, 155 F. 3d 331 (4<sup>th</sup> Cir. 1998)

which Franchisor believes will enhance the System, including, among other things, the costs of preparing and conducting media advertising campaigns, including print, radio and television advertising; Internet advertising; direct mail advertising; marketing surveys; employing advertising and/or public relations agencies to assist therein; purchasing promotional items; and providing promotional and other marketing materials and services to the businesses operating under the System. The Fund may be used to reimburse Franchisor or its affiliates for the internal expenses of operating an advertising department and administering the advertising program. Reimbursement of internal expenses shall not exceed ten percent (10%) of all contributions to the Fund.

Upon request, Franchisee is entitled to receive from Franchisor, within 120 days of the end of Franchisor's most recent fiscal year, an annual report of expenditures of advertising fees contributed to the Fund.

Nothing contained herein shall be deemed to impose on Franchisor any fiduciary duties or to create between Franchisor and Franchisee any fiduciary relationship.

All advertising and promotion by Franchisee shall be in such media and of such type, format and other particulars as Franchisor may approve, shall be conducted in a dignified manner, and shall conform to such standards and requirements as Franchisor may specify. Franchisee shall not use any advertising or promotional plans or materials unless and until Franchisee has received written approval from Franchisor, pursuant to the procedures and terms set forth in Section \_\_\_\_ hereof.

Franchisee shall submit samples of all advertising materials to Franchisor, for its prior approval by Franchisor. Franchisee shall not use the materials until they have been approved by Franchisor. If written notice of disapproval is not received by Franchisee from Franchisor within thirty (30) days of the date of receipt by Franchisor of such samples or materials, Franchisee [not] shall be permitted to use them. Franchisee must cease to use any advertising disapproved by Franchisor immediately upon notice from Franchisor.



## **F. Other Provisions**

There are, of course, many other provisions that are found in practically every franchise contract. For example, the circumstances under which a franchisor may terminate the franchise agreement for a franchisee's default may be greatly limited by state franchise relationship statutes and the franchise agreement should delineate the circumstances under which the franchisor will permit the franchisee to cure a particular default and under which circumstances the default may lead to termination.<sup>20</sup> Many franchise agreements also include non-disclosure, non-competition, non-solicitation and other covenants protecting the franchisor (both during the term of the franchise agreement and after its termination or expiration), the system and other franchisees from competition from a franchisee or a former franchisee. The enforceability of these provisions is very much an issue of state law and some of these clauses may not be appropriate in particular industries.<sup>21</sup>

Like any other skill, drafting a franchise agreement requires practice and patience. Although the provisions and issues discussed in this paper are not exhaustive of those that a novice drafter must consider when drafting a franchise agreement, they serve as representative illustrations of the types of provisions and issues that must be addressed in each franchise contract.

## **V. CONCLUSION**

It is impossible to foresee every possible dispute, but history has provided the benefit of experience from which every franchise counsel can benefit. Case law and state franchise relationship statutes provide an essential backdrop to every franchise contract. If a franchisor (or a franchisee) does not fully appreciate their rights and obligations resulting from this backdrop, the contract into which they enter may be based on differing understandings of the parties' responsibilities under it. This could create a fertile territory for acrimony and litigation. But, if franchise counsel appreciates the unique nature of franchising and understands the statutory regime and case surrounding it, they can draft a contract that will be much more likely to memorialize the parties' intentions and avoid costly disputes.

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<sup>20</sup> For a more thorough discussion of the issues to be considered when drafting provisions relating to a franchisee's default, see Section III.D, *supra*.

<sup>21</sup> For an excellent survey of the state laws relating to covenants not to compete, see Klarfeld, Peter, *Covenants Against Competition in Franchise Agreements*, Amer. Bar Assn. 2d Ed (2003).

## SAMPLE DEFINITIONS

**"Business Day"** means any day other than Saturday, Sunday or any other day that Franchisor designates in the Manuals as a non-business day.

**"Advertising Fund"** means a fund established by or at the direction of Franchisor and expended for purposes authorized by this Agreement.

**"Affiliate"** means a Person that controls, is controlled by or is under common control with another Person, either by virtue of equity ownership, by contract or by other means.

**"Business Entity"** means a corporation, a general or limited partnership, or a limited liability company.

**"Computer System"** means all computer hardware components and software applications, including future enhancements, additions, substitutions, upgrades and modifications, used or required for use in connection with the operation of the Franchised Business.

**"Confidential Information"** means all trade secrets (as defined under applicable law), the Standards, all information contained in the Manuals, the names and contact information concerning all customers and potential customers of the Franchised Business; and all other information that Franchisor designates as "Confidential Information" for purposes of this Agreement.

**"Copyrighted Works"** means all tangible media of expression, including, without limitation (a) the Manuals, (b) all documents reflecting the Standards, and (c) the content and design of all advertising and promotional materials, created by, owned by, or licensed for use by Franchisor or its Affiliate in connection with Franchisee's operation of the Franchised Business.

**"Force Majeure"** means acts of God, strikes, lockouts or other industrial disturbances, war, riot, epidemic, fire or other natural catastrophe, terrorist acts or government actions resulting from terrorist acts, or other forces beyond your control which materially and adversely affect the condition or use of the location for purposes of operating a Franchised Business.

**"Franchised Business"** means a business that is identified by the Marks, and is operated at the Approved Location in accordance with the System, all pursuant to the terms and conditions of this Agreement.

**"Gross Revenues"** means all income of every kind and nature derived from the operation of the Franchised Business, whether for cash or credit and regardless of collection in the case of credit. Each charge or sale upon installment or credit will be treated as having been received in full at the time such charge or sale is made, regardless of the time that you actually receive payment. Gross Revenues does not

include the amount of any sales tax or similar tax imposed by any federal, state, municipal or other government authority that Franchisee collects and properly remits to the taxing authority.

**"Intellectual Property"** means all Marks, Confidential Information, Copyrighted Works, and patented designs and processes created by, owned by, or licensed for use by Franchisor or its Affiliate in connection with Franchisee's operation of the Franchised Business.

**"Local Marketing"** means marketing activities conducted in your Protected Area that conform to the Standards.

**"Logoed Items"** means any item or merchandise bearing the Marks including, without limitation, accounting sheets, envelopes, business cards, shirts, hats, and other promotional items.

**"Manual"** means and collectively includes all manuals, policy statements, directives, bulletins and memoranda that contain prescribed or recommended specifications, standards, procedures, policies, advice, and training relating to the operation or promotion of the Franchised Business.

**"Marks"** means the trade name and trademark and all additional and replacement trademarks, service marks, logos, slogans and other indicia of origin that Franchisor designates for use in connection with the Franchised Business.

**"Principal"** means any Person having the right to exercise management control over, or having an equity or beneficial interest, the Franchisee. It includes all officers, directors and shareholders of a corporation, all members and managers of a limited liability company, and all limited and general partners of a general partnership (and all of the general partner's "Principals").

**"Standards"** means the standards, specifications, policies and techniques that Franchisor has developed and may change periodically for locating, establishing, managing, operating, advertising for and promoting a Franchised Business. They include, among other things, required and recommended business practices; mandatory and suggested accounting practices and recordkeeping procedures; standards and specifications for building design, decor, trade dress, equipment and layout; training, licensing and employee qualifications; dress code requirements; and supplier restrictions.

**"System"** means Franchisor's proprietary business system for providing \_\_\_\_\_. The distinguishing characteristics of the System include, without limitation, use of the Intellectual Property and Standards.

**"Transfer"** means and includes (1) the sale, assignment, transfer, conveyance, gift, pledge mortgage, or encumbrance of Franchisee's rights or interest in this Agreement



or in all or substantially all of the assets of the Franchised Business or in this Agreement; or (2) the sale or assignment of a Principal's equity interest in the Franchisee.