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GROWING PAINS: COUNSELING THE EMERGING FRANCHISOR

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I. INTRODUCTION

While much has been written on the topic of how to advise the startup franchisor, as well as the more established and large franchise system, there are relatively fewer resources on the unique issues and considerations when counseling the "emerging franchisor" who is getting ready to scale its franchise network by implementing an aggressive growth strategy. Of course franchisors of all sizes and at all stages share common legal and business issues, but emerging franchisors will be well-advised by an attorney who understands that the challenges emerging franchisors face will continue to evolve and shift over the initial five to ten years of operations and, better yet, by the franchise lawyer who can help them reassess and, if necessary, adapt their legal documents, business practices, and processes for success during this all-important phase of the franchise system.

This paper explores some of the key issues that emerging franchisors face as they attempt to manage their increasingly complex businesses, provide day-to-day support and guidance to their existing franchisees, and continue to grow the brand and sell additional franchises, while at the same time determining what changes may be necessary to accommodate and support their strategy for rapid growth, including restructuring and investing in internal and external resources, possible changes to the original business model, and updates or upgrades to their key legal documents and franchise sales and compliance processes. Topics also include counseling emerging franchisors in preparing annual franchise disclosure document ("FDD") updates and renewals of state registrations, monitoring, and ensuring compliance with the franchise agreement and enforcing system standards, maintaining complete and accurate records, and addressing dissatisfied franchisees.

II. SYSTEM EVOLUTION

Successful franchise systems are continually adapting to changes in the competitive landscape, evolving consumer tastes, and demands and general trends in the market and economy, as well as feedback from existing and prospective franchisees. Early-stage franchisors are likely to implement significant changes to their original franchise business model, particularly in the first few years of operation as they respond to negotiations with their initial pipeline of franchisee candidates, adapt their growth strategy, and modify the franchise system in light of "real world" learnings from licensing their systems, methods, and know-how to third party franchisees.

A. Refine Qualification Criteria for Prospective Franchisees

A well-advised startup franchisor will have spent time up front with its business and legal advisors developing a list of personal attributes, educational background, business experience, and financial profile of the ideal candidate for the franchise system. This likely resulted in a detailed franchisee application or questionnaire that the franchisor has been using as part of its sales process in order to screen candidates and hopefully allow it to quickly distinguish between "tire kickers" and genuinely interested and qualified candidates.[1]

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[1] *See* Jim Meaney & Max Schott, II, *Starting a Franchise System: Practical Considerations, Planning and Development*, ABA 33RD ANNUAL FORUM ON FRANCHISING W-24, at 20-21 (2010).

The startup franchisor and its business advisors will also likely have developed this initial profile and franchisee application form based on a set of assumptions and predictions about the economics and profit margins of the franchised business, the costs of establishing and operating the franchised unit, and the franchisee's potential return on investment. After the initial stage of growth, and armed with the benefit of actual unit level financial information and experience dealing with its first cohort of franchisees, the emerging franchisor should revisit its initial profile and franchisee application form and assess whether changes to the economic profile and other attributes of the ideal candidate are required.

Despite the best of intentions, many startup franchisors are so keen to make their first few franchise sales that they sometimes overlook gaps in the franchisee's experience or make concessions around the candidate's net worth or working capabilities. As a result, the emerging franchisor may be dealing with one or more underperforming franchisees and, in some cases, may be struggling with how to monitor franchisees and enforce system standards with their initial slate of franchisees – and may have even issued its first few notices of default or termination. A more rigorous candidate screening process will need to be developed and implemented by the emerging franchisor before it begins to scale the business, or the franchisor runs the risk of having an increasing number of franchisees who are not a good fit for the business from an operational and/or financial perspective.

B. <u>Adapting the Franchise Agreement for Growth</u>

In the early days, startup franchisors, particularly those with a small number of corporate units or an untested concept or relatively unknown brand, often find themselves having to negotiate the financial terms of their template franchise agreement or make concessions to key legal terms in order to close the deal. As a result, they may have a large number of special deals, including lower initial franchise fees and reduced or waived royalty fees. In addition, they may not have been able to secure personal guarantees due to the untested nature of the concept and may have waived certain in-term or post-term non-competition covenants in order to attract an experienced candidate.

As the emerging franchisor begins to scale, it will become administratively more burdensome to manage these one-off concessions and, from both an operations and relationship perspective, the need for consistency in the commercial terms across the network will become more and more important as the franchisor evolves from startup to emerging franchisor. Some of these negotiated changes and comments from the franchisees' lawyers may be an indication that it is time to revisit the terms of the initial form of franchise agreement used to launch the business, particularly where the same feedback is being provided time and time again. Now is the time to undertake a "best practices" review of the franchise agreement with the twin objectives of protecting the franchisor's interests and ensuring the financial terms are reasonable in light of the return on investment experienced by the early franchisee cohort. The franchisor may also want to assess whether the amount of the initial franchise fee is adequate to cover the franchisor's costs of onboarding and training new franchisees or whether an adjustment would be prudent prior to scaling the business. A similar assessment should be done with respect to other fees, including renewal fees and transfer fees, as well as ongoing fees such as royalty fees and advertising contributions.

The franchise agreement may also need to be modified to reflect changes in the franchisor's business model, as the brand becomes more sophisticated, organized, and experienced. For example, most startup franchisors reserve the right to establish a national advertising fund or local advertising cooperatives. Similarly, the startup franchisor is unlikely to have established a franchisee advisory council, but may have decided to enhance franchisee relations and input by putting one in place coincident with launching its growth strategy. These types of operational changes will need to be reflected in the FDD and the template franchise agreement and other documents and contracts that are part of the franchise system.

In many cases, the emerging franchisor will be set to scale its business for growth coincident with the timing of the renewal anniversary of its first cohort of franchisees (typically between the fifth and tenth year after commencing franchise sales). The franchisor will need to prepare a renewal form of franchise agreement and develop an internal process and timeline for managing the renewal process, including a system to assess whether the franchisee meets the conditions of renewal set out in its current franchise agreement (which typically includes a requirement that the franchisee has operated the franchise in substantial compliance with the franchise agreement throughout the initial term and may include an assessment of whether the franchisee's location remains suitable).

Most franchise agreements provide the franchisor with the right to require the renewing franchisee to sign the franchisor's then-current form of franchise agreement, such that the renewal process provides an opportunity to convert early franchisees to the emerging franchisor's "new and improved" form of franchise agreement that is being used. However, emerging franchisors should be prepared for possible pushback and negotiations with its first cohort of renewing franchisees who may have been provided with more favorable economic and business terms when the franchise system was initially launched. To avoid this issue, most franchisors include in their franchise agreement an explicit requirement that the franchisee sign the then-current form of agreements, and if any concessions were previously granted, limit those concessions to the initial term only. Any concessions or special terms ultimately negotiated with these renewing franchisees should be documented through the use of an amending agreement to the standard form renewal franchise agreement in order to help track these unique commercial arrangements.

C. Alternative Models to Help Scale More Quickly

Many franchisors launch their franchise business leveraging the direct franchising, single-unit model which involves entering into a separate franchise agreement with individual franchisee candidates who are granted the right to operate only one unit. While this "slow and steady" single unit approach is often a wise strategy for the startup franchisor as they continue to refine their unit level operations and look for the right candidates, the emerging franchisor may consider bolstering this model with a multi-unit or area development model to help scale their business more quickly. This shift in approach to scale has implications on the emerging franchisor's forms of franchise agreements as they will require new forms of agreements, as well as related changes and disclosures to the FDD.

D. Refine the System

1. Operations Manuals

In most developed franchise systems, and certainly prior to scaling the system for growth, the emerging franchisor will have prepared an operations manual which contains mandatory and suggested specifications, standards, procedures, and methods applicable to the franchised business. The operations manual should be treated as a living document and be regularly updated to preserve and enhance the public image of the franchise system, to accommodate changing consumer trends, and to ensure the continuing efficiency of the franchise system generally. The manual should also be updated from time to time to keep pace with developments in the law.

Under the franchise agreement, the franchisee will be required to abide by and adopt all such additions, modifications, withdrawals and other revisions to the operations manual. When modifying the manual, franchisors should be aware of their general duty of good faith and fair dealing and should consider whether the revisions unreasonably alter the franchisee's rights under the franchise agreement. It is not uncommon for a startup franchisor to continuously add to and develop its operations manuals as it grows. Eventually, as the system evolves, the emerging franchisor should revisit the depth and scope of its operations manual to ensure that it does not become a how-to manual of operating a business (which can create vicarious liability issues) or otherwise invite joint employment liability on the franchisor. Rather, the operations manual should detail the specifications and standards of operations that are material to protecting the brand.

2. <u>Initial Training and Operating Support</u>

Virtually every franchise agreement will deal with the question of initial training of the franchisee prior to opening the business to the public. Training programs may consist of a combination of classroom training, field experience, online education, training manuals, and on-site startup training prior to opening. The emerging franchisor may wish to update its initial training programs to reflect learnings from its early franchisees prior to scaling the business. The emerging franchisor may also be in a position to involve some of its stronger performing franchisees in training its next slate of new franchisees and/or to convert one of its corporate locations to a training center for new franchisees joining the system.

The franchise agreement should also specify in detail what type of operating assistance the franchisor will provide to the franchisee during the term of the agreement. For example, the franchise agreement may specify that the franchisor may provide operating assistance in the form of site selection evaluation, inspections and evaluations of the franchisee's performance, periodic advice related to local advertising and promotional activities, formulation of national and regional advertising and promotional programs, and initial and ongoing training on system standards and operations.

The franchise agreement may also specify that the franchisor has the right to require the franchisee to participate in refresher and/or ongoing training programs as well as to attend regional or national conferences. Although the emerging franchisor will be focused on onboarding new franchisees to the system, it will not want to lose sight of underperforming franchisees, franchisees who are coming up for renewal and the need for more general ongoing or refresher training (particularly where there have been modifications to the system in connection with the growth strategy) to ensure the overall health of the network.

E. <u>Launch an Advertising Fund</u>

Most franchise agreements provide the franchisor with the ability to establish and require franchisees to participate in national and/or regional advertising programs and to contribute to a national and/or regional advertising fund. Sometimes, the startup franchisor has not yet established a national and regional advertising fund and therefore is not yet collecting advertising fees from its franchisees. In other cases, the startup franchisor does collect these fees right away (which is the better practice), but may or may not use those funds in the most efficient way. As the franchisor transitions from startup to emerging franchisor, the franchisor will often consider establishing or growing an advertising fund and formalizing its advertising program as a means of leveraging its growth and further enhancing the brand and consumer awareness for the benefit of the entire system.

If an advertising program is established, it should be supported by contributions from all franchisees in the system. The startup and emerging franchisor is well-advised not to waive contributions to regional and national advertising funds as these funds are intended to be used for the benefit of the entire system. These types of "special deals" with early-stage franchisees can create relationship issues down the road, as franchisees are likely to complain they are subsidizing non-contributing franchisees.

Once the advertising fund is established, contributions to the fund should be accounted for separately form the general revenues of the franchisor. However, the franchise agreement should be clear that the contributions are not held in trust by the franchisor and may be commingled with the franchisor's general operating accounts.

The purpose of the advertising fund should be specified in the franchise agreement. Generally, the franchisor will state that the fund is to be used for the purpose of purchasing or financing the production of media commercials and advertisements and that the contributions will be used for, among other activities, media costs, commissions, market research costs, creative and production costs, and other costs relating to advertising and promotional programs undertaken by the franchisor. The franchise agreement should also permit advertising fund disbursements to pay for external and in-house marketing staff that the franchisor retains for marketing, as well as the costs of administering the fund. This type of permissible use of fund amounts would facilitate a franchisor to launch an in-house marketing team that can aid franchisees in marketing initiatives (particularly online/social media). The franchise agreement will also typically provide that all decisions regarding expenditures from the fund, including selection of the particular media and advertising content, will be entirely within the sole discretion of the franchisor.

The franchisor will want to establish processes and procedures that create transparency with its franchisees about how the advertising contributions are being expended. The franchisor should report to franchisees on a regular basis, typically annually, about contributions to and expenditures from the fund. The franchise agreement may even provide that a separate financial report will be provided to franchisees for this purpose, although typically the report is prepared internally by the franchisor and is not prepared on an audited or review engagement basis.

As the franchisor continues to grow, franchisee advisory councils (and in some cases independent franchisee associations) may be involved in the administration of the advertising programs. In such cases, the franchise agreement may provide that the franchisor will consult from time to time with a committee composed of representatives of the franchisees of the system or a subcommittee of the franchisee association with respect to the development, conduct, and administration of the advertising and promotion programs. However, the franchise agreement will typically provide that all ultimate decisions regarding the manner and use of the advertising contributions, the scope of the advertising and promotion to be carried out and the selection of the particular media and content will be within the sole discretion of the franchisor.

F. <u>Establish a Franchisee Advisory Council</u>

As the startup franchisor transitions to emerging franchisor with a particular focus on growth, the franchisor should be prepared for a number of challenges that may present themselves, including new pressures on the franchisor's ability to remain in regular contact with all of its franchisees and to communicate effectively with a growing network of franchisees who may be increasingly geographically diverse. The emerging franchisor may also be facing its first experience with franchisees who are unhappy or disgruntled with the direction of the brand or some of the changes being implemented in connection with the franchisor's strategy to scale the business.

The emerging franchisor may want to consider forming a franchisee advisory council ("FAC") in order to help address some of these challenges. An FAC is typically created by a franchisor to foster constructive, two-way communications with its franchisees by having a select group of franchisees regularly meet with the franchisor to discuss matters of mutual interest. The franchisor will usually prepare the FAC's terms of reference, including establishing a method for member selection, setting out the roles and responsibilities of FAC members, and creating policies and procedures for the operation of the FAC. There will be additional considerations when drafting the terms of reference depending on the structure, goals, and operation of the FAC.

An FAC is very different from an independent franchisee association, which is typically formed by a system's franchisees in times of actual or threatened disputes in an attempt to create collective or consolidated bargaining power with the franchisor. A common basis for the creation of an association is a belief by franchisees that their viewpoints are being ignored by the franchisor. Accordingly, having an effective FAC that clearly illustrates to franchisees that the FAC has meaningful input into proposed system changes can help avoid the formation of a franchisee association.

III. ANNUAL FDD UPDATES AND RENEWALS OF STATE REGISTRATIONS

As the startup franchisor gains experience, its franchise system is likely to evolve, and the franchisor may introduce new or modified products and services in response to changes, expansions, concerns, or issues raised by franchisees and their customers, as well as, to keep pace with industry trends and overall market conditions. These growing pains are an inevitable part of an emerging franchisor's life. Failure to adapt and adjust is likely to result in slower or sustained growth of the system.[2] In most cases, these changes will require revisions to the franchisor's FDD and agreements, which may be made at the time of its annual renewal or mid-year via a post-effective amendment.

A. <u>Preparation/Update of FDD</u>

For an emerging franchisor, some common parts of the FDD that change year-to-year (or more frequently) include the following:

- Item 1 – corporate restructuring, especially in the event of a private equity investment or purchase or other acquisition of the franchisor.
- Item 2 – personnel with management responsibility related to franchise operations or sales.
- Item 5 – initial fees.

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[2] *See, e.g.*, Ed Teixeira, *The State of Emerging Franchise Systems: Challenges and Opportunities, Part Two*¸ FRANCHISE GRADE, at 11 (Dec. 21, 2017), assets.franchisegrade.com/files/reports/analysis_of_emerging_franchises_2.pdf ("As franchise systems grow franchise leadership should be prepared and willing to adjust their franchise program. Too often, a floundering franchise is unwilling or incapable of making changes to their franchise, the result is wasting resources trying to sell a flawed system.").

- Item 6 – ongoing fees.
- Item 7 – initial estimated investment.
- Item 8 – supplier relationships and restrictions.
- Item 11 – training, marketing, and other pre-opening and ongoing obligations of the franchisor.
- Item 19 – financial performance representations.[3]
- Item 20 – lists and charts of current and former franchisees.
- Item 21 – financial statements.[4]

Of course, the above list is by no means an exhaustive list of changes that a franchisor may have. Emerging franchisors should communicate frequently with their counsel as their systems evolve to determine whether the change or modification requires revising their FDD or agreements.

1. Financial Statements

Franchisors with three or more fiscal years of operating history must include in their FDDs two fiscal years of audited balance sheets and three fiscal years of audited statements of operations, stockholders' equity, and cash flows.[5] In non-registration and notice states, the FTC Franchise Rule[6] allows startup franchisors that do not already have audited financial statements to initially use unaudited financial statements and gradually phase-in audited financial statements over three years.[7] The phase-in of audited financial statements for startup franchisors is handled differently in the registration states under the North American Securities Administrators Association's 2008 Franchise Registration and Disclosure Guidelines: Hawaii, Illinois, and Washington permit the phase-in of audited financial statements;[8] Maryland, North Dakota, and Rhode Island permit the phase-in of audited financial statements only if the franchisor agrees to financial assurances (escrows, fee deferrals, or surety bonds);[9] California does not permit the phase-in of audited financial statements (requiring the immediate use of audited financial statements), except in limited circumstances;[10] and Minnesota, New York, and Virginia require

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[3] *See infra* Section III.A.2.

[4] *See infra* Section III.A.1.

[5] 16 C.F.R. § 436.5(u).

[6] 16 C.F.R. Part 436.

[7] *Id.*

[8] HAW. CODE R. § 16-37-3; ILL. ADMIN. CODE tit. 14, § 200.600; WASH. ADMIN. CODE § 460-80-140.

[9] MD. CODE REGS. § 02.02.08.13; BUS. FRANCHISE GUIDE (CCH) ¶ 5340.50; N.D. CENT. CODE § 51-19-07; R.I. GEN. LAWS § 19-28.1-9.

[10] California allows reviewed financial statements in the initial filing so long as audited financial statements have never otherwise been prepared, and then only audited financial statements thereafter. CAL. CODE REGS. tit. 10, § 310.111.2.

the immediate use of audited financial statements.[11]

2. Financial Performance Representations (Item 19)

The FTC Franchise Rule regulates franchisors' use of "financial performance representations", or "FPRs," defined as

> any representation, including any oral, written, or visual representation, to a prospective franchisee, including a representation in the general media, that states, expressly or by implication, a specific level or range of actual or potential sales, income, gross profits, or net profits. The term includes charts, tables, or mathematical calculations that show possible results based on a combination of variables.[12]

All FPRs, in either a historical or forecasted representation, must have a reasonable basis, and the franchisor must provide written disclosure of such claims to a potential franchisee in the FDD.[13] FPRs are optional, but can be a valuable sales tool. FPRs are usually closely examined by state franchise regulators to ensure they have a reasonable basis and are not misleading. But what constitutes a reasonable basis can be subjective, and therefore Item 19 disclosures are frequently the target of comments from state franchise regulators.

Initially, if desired by the franchisor, a startup franchisor will only be able to present an FPR based on its company-owned outlets.[14] Assuming the franchisor wants to continue providing an Item 19 disclosure once it starts selling franchises, and after those franchises have been operating for at least a year, the emerging franchisor that elects to present an FPR must start basing its FPR on franchised outlets.[15] Even if the franchisor wished to present an FPR based upon the gross profit or net profit of only company-owned outlets, it must present "(a) gross sales data from operational franchise outlets, when the franchisor has operational franchise outlets; (b) actual costs incurred by company-owned outlets; and (c) supplemental disclosure or adjustments to reflect all actual and reasonably expected material financial and operational differences between company-owned outlets and operational franchise outlets."[16]

However, if the franchisor has less than ten operating franchises, it may merge the data of the company-owned and franchisee-owned outlets into a single combined FPR without disclosing the data from the company-owned and franchisee-owned outlets separately.[17] The

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[11] MINN. STAT. § 80C.04(g); N.Y. GEN. BUS. LAW § 683(g); 21 VA. ADMIN. CODE § 5-110-30(A)(7).

[12] 16 C.F.R. § 436.1(e).

[13] *Id*.

[14] N. AM. SEC. ADM'R ASS'N, NASAA FRANCHISE COMMENTARY FINANCIAL PERFORMANCE REPRESENTATIONS § 19.9 (2017), https://www.nasaa.org/wp-content/uploads/2017/05/Financial-Performance-Representation-Commentary.pdf [hereinafter "NASAA FPR COMMENTARY"]. A franchisor with no operational franchisees may present an FPR of the gross sales of its company-owned outlets alone.

[15] *Id.* at § 19.8.

[16] *Id.* at § 19.10.

[17] *Id.* at § 19.11.

franchisor must include a representation that there are no material differences in the gross sales of company-owned and franchisee-owned outlets.[18] Once the franchisor reaches ten or more franchises, it may still present a combined company-owned and franchisee-owned FPR, but then must also disclose each subgroup individually.[19] In the authors' experience, most emerging franchisors do not combine the data even if there are less than ten operating franchisees.

Note, however, that any FPR must have a reasonable basis and must be based on accurate underlying sales and/or expense data.[20] Many startup franchisors, unfortunately, do not have reliable information on franchised outlet sales figures. Likewise, many emerging franchisors do not have systems in place to accurately track expenses of franchised outlets. Franchisors should ensure that their franchise agreements grant the franchisor the right to obtain financial statements of franchisees, and to disclose them (in the aggregate) in the franchisor's FDD.

The FTC Franchise Rule allows for an FPR that is a forecast of future financial performance, provided that the material basis and assumptions on which the projection is based are disclosed.[21] State franchise regulators review historic FPRs meticulously; projections are even more speculative.[22] A franchisor should consider the following factors when making a projection: economic or market conditions that are basic to a franchisee's operation, costs of goods or services sold, and operating expenses. Projections that appear to lack a reasonable foundation will be rejected by state franchise regulators. In the authors' collective experience, most franchisors do not use projections – even though permitted – because of the difficulty of establishing a reasonable basis for the projections and the likelihood of misleading potential franchisees. Thus, while tempting to present forecasts and projections, counsel to startup or emerging franchisors should strongly favor historical FPRs only.

Canadian franchise legislation provides that the provision of an earnings projection is voluntary, but if a franchisor elects to provide an earnings projection, the earnings projection must be included in the disclosure document and it must be accompanied by certain prescribed information. The disclosure regulations in Prince Edward Island, New Brunswick, Manitoba, and British Columbia define an "earnings projection" to:

> include any information given by or on behalf of the franchisor or the franchisor's associate, directly or indirectly, from which a specific level or range of actual or potential sales, costs, income, revenue or profits from the franchises or businesses of the franchisor, franchisor's associates or affiliates of the franchisor of the same type as the franchise being offered can easily be

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[18] *Id.*

[19] *Id.*; *see also* Dale Cantone, Lulu Gomez & David Gurnick, *Promises, Promises: Financial Performance Representations – Advanced Issues*, ABA 43RD ANNUAL FORUM ON FRANCHISING W-16, at 7-22 (2020).

[20] 16 C.F.R. § 436.5(s)(93); FED. TRADE COMM'N ("FTC"), FRANCHISE RULE COMPLIANCE GUIDE at 85 (May 2008), https://www.ftc.gov/system/files/documents/plain-language/bus70-franchise-rule-compliance-guide.pdf [hereinafter "FTC COMPLIANCE GUIDE"].

[21] 16 C.F.R. § 436.5(s)(3)(i); *see also* FTC COMPLIANCE GUIDE, *supra* note 20, at 91–92, 135–36.

[22] *See* Cantone, et al., *supra* note 19, at 27–30.

ascertained.[23]

While the Ontario legislation does not expressly define an "earnings projection", courts are likely to adopt a similarly broad interpretation of what constitutes earnings claims or earnings projections under the legislation. Accordingly, Canadian franchisors, as well as US franchisors, are well-advised to carefully consider the nature of any financial information provided to franchisees at any time before or during the disclosure process in order to avoid inadvertently providing an earnings projection. Any earnings information that is discussed or provided to candidates must be included in the FDD and accompanied by all prescribed information and appropriate disclaimers. Failure to do so could lead not only to a rescission claim for a deficient disclosure document, but also a common law and/or statutory damages claim for misrepresentations in the FDD due to the omitted information. The emerging franchisor should also be aware that there are unique considerations when the FDD relates to an existing corporate or franchised location that is being converted or transferred to a new franchisee, as it may be necessary to include site specific historical financial information on the basis that this information constitutes a "material fact" under the provincial franchise legislation.

B. State Registration Renewals

Pursuant to the FTC Franchise Rule, a franchisor must update its FDD at least annually – and possibly sooner upon a material change or event to the franchisor or its franchise system.[24] There are also 14 states with franchise registration and disclosure laws (in addition to franchise relationship laws): California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin.[25] In addition to complying with the FTC Franchise Rule, most of these states' franchise registration and disclosure laws impose on the franchisor an annual registration requirement. Michigan and Wisconsin have opted for merely a notice filing, with no substantive review of the FDD prior to registration. The other states have chosen a more proactive approach, pursuant to which both the franchisor seeking to offer franchises and the FDD it intends to utilize to do so, are closely scrutinized by a state franchise regulator before any franchise registration may be approved. These states review the documents to ensure that all proper disclosures are made as required under state law and the FTC Franchise Rule, and may also review the financial wherewithal of the franchisor (discussed in Section III.B.3 below).

Emerging franchisors should carefully consider in which states they plan to offer franchises for that year. The registration states impose a registration fee for initial (first time) filings and for each annual renewal, which generally range from $150 to $750 per state. It also may be useful to consider the standard review process used by the various states and turnaround time to determine how difficult it would be to add a state registration mid-year if the franchisor has a

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[23] N.B. Reg. 2010-92. § 2(1) (New Brunswick); *see also* Franchises Act, P.E.I. Reg.F-14.1. § 1(1)(c) (Prince Edward Island); M.Reg. 29/2012. §1(1) (Manitoba); B.C. Reg. 238/2016. § 1(1) (British Columbia).

[24] 16 C.F.R. § 436.7.

[25] CAL. CORP. CODE §§ 31000-31516; HAW. REV. STATUTES § 482E; 815 ILL. STAT. § 705/1 *et seq.*; IND. CODE § 2.5; MD. CODE ANN., BUS. REG. §§ 14-201 to 233; MICH. COMP. LAWS Ch. 445; MINN. STAT. § 80C; N.Y. GEN. BUS. LAW §§ 680-695; N.D. CENT. CODE § 51-19; R.I. GEN. LAWS § 28.1; S.D. CODIFIED LAWS § 37-5B; VA. CODE §§ 13.1-557 to -574; WASH. REV. CODE § 19.100; WIS. STAT. § 553.

prospect in that state.[26] Some states conduct a thorough review of initial and renewal registration applications, and therefore the franchisor may need to wait several months (depending on the state, time of year, and extent of any comments) before the registration is made effective. For these reasons, most startup franchisors only focus on a few franchise registration states during their initial filings, and may add additional states either during the year or at the time of renewal. Most startup and emerging franchisors do not register in all fourteen franchise registration states.

1. Annual Updates

Once a franchisor has prepared its initial FDD and filed and registered the franchise offer (or obtained an exemption) as required under the state franchise registration and disclosure statutes mentioned above, the franchisor must revise and update the FDD at least annually. This update is required within 120 days after the end of the franchisor's fiscal year, but may be sooner under certain state laws.[27] For a growing franchisor, the annual renewal is an opportune time to review the FDD in its entirety and modify the franchise system parameters as needed, whether it be personnel listed in Item 2, the estimated initial investment required in Item 7, fees payable by franchisees as listed in Items 5 and 6, the initial training program described in Item 11, or various elements of the franchise agreement in order to make adjustments to various provisions based on the prior year's lessons and future goals. It is not uncommon for an emerging franchisor to go through some growing pains as it fine-tunes the system and finds out – often the hard way – as to what is market and what provisions prospective franchisees frequently balk at. Franchisors can update the FDD at any time during the year, but this comes with additional cost and down-time (described in Section III.B.2 below). Therefore, at a minimum, franchisors should compile these changes throughout the year and discuss them with counsel so that they can be incorporated into the FDD during the annual renewal process.

As indicated above, most of the franchise registration states reserve the right to – or do in fact – review the FDD before issuing an approval. In doing so, these states will not only check for proper disclosure of all required items under state and federal law, but also review the financial statements of the franchisor, as discussed in Section III.B.3 below.

It is not uncommon for a state examiner to issue a comment letter as a result of its review. Responding to a comment letter requires either (a) acknowledging the changes requested by the state franchise examiner, and enclosing the documentation requested in the comment letter, such as a blackline and clean version of the changed pages (if pagination did not change) or an entire FDD; or (b) respectfully challenging the changes requested. The franchisor will have to wait before offering or selling in that state until it hears back from the state franchise regulator, which may take several weeks during March and April, when most brands (since many brands have a fiscal year end of December 31) will be updating their FDDs and renewing their state registrations within

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[26] For example, certain states, such as Indiana, Michigan, South Dakota, and Wisconsin, typically require "notice" only registrations that are effective upon receipt. *E.g.*, IND. CODE § 23-2-2.5-10.5(d); MICH. COMP. LAWS § 445.1507a; S.D. CODIFIED LAWS § 37-5B-5; WIS. STAT. § 553.26.

[27] 16 C.F.R. § 436.7; HAW. REV. STAT. § 482E-3(d) (90 days after fiscal year end for Hawaii); CAL. CODE REGS. tit. 10, § 320.120 (110 days after fiscal year end for California); *see also* Leslie D. Curran, David W. Oppenheim & Max J Schott, II, *Franchise Disclosure and Sales Compliance*, *in* FRANCHISE LAW COMPLIANCE MANUAL 55, 174–77 (Elizabeth S. Dillon & James A. Goniea eds., 3rd ed. 2021) (for a comprehensive chart denoting state renewal timings); *see also* Joseph J. Fittante, Jr. & Suzanne Trigg, *Registration*, *in* FUNDAMENTALS OF FRANCHISING 141, 149–61 (Rupert M. Barkoff, et. al. eds., 4th ed. 2015) (for a breakdown of renewal timing strategy).

120 days after the fiscal year end.

If the franchisor makes a change in a particular state based upon a comment received from a state franchise regulator, the franchisor must either:

(a) make the change in the FDD used nationwide (the multi-state FDD), file the revised FDD with the state (as instructed in the comment letter), and then either (1) cross-file the revised FDD in all other franchise registration states if the change was material; or (2) not cross-file the revised FDD in other franchise registrations if the change was not material[28]; or

(b) make the change in a separate, state-specific FDD and file the revised FDD with the state (as instructed in the comment letter), then the franchisor's sales team must use this state-specific FDD for offers or sales in that state.

2. Material Changes

In addition to the annual update requirement, both the FTC Franchise Rule and state franchise registration/disclosure statutes require franchisors to amend their FDDs upon the occurrence of any material change (the required time for making such amendments ranging from promptly after the material change to quarterly). A "'material change' includes a fact, circumstance, or condition which would have a substantial likelihood of influencing a reasonable prospective franchisee in the making of a decision relating to a franchise business"[29] or which has any potential significant financial impact on a franchisee or prospective franchisee. If any of the following occur, which examples are taken from the Minnesota statute relating to "material event or change", the franchisor should assume that there may be some filing requirements, or some need to change its FDD, and it should contact its counsel immediately (and halt sales):

A. the termination, closing, or failure to renew by the franchisor during any consecutive three-month period after registration of ten percent of all franchises of the franchisor, regardless of location, or ten percent of the franchises of the franchisor located in the state . . . ;

B. any change in control, corporate name, or state of incorporation, or reorganization of the franchisor;

C. the purchase by the franchisor during any consecutive three-month period after registration of ten percent of its existing franchises, regardless of location, or ten percent of its existing franchises in the state . . . ;

D. the commencement of any new product, service, or model line involving, directly or indirectly, an additional investment

[28] However, it may be good practice to still send a friendly letter to the state franchise regulators in the other registration states informing them of the change requested by the other state franchise regulator should another state require the franchisor to file the revised FDD there as well.

[29] VA. ADMIN. CODE § 5-110-10.

in excess of 20 percent of the current average investment made by all franchisees or the discontinuation or modification of the marketing plan or marketing system of any product or service of the franchisor where the average total sales from such product or service exceeds 20 percent of the average gross sales of the existing franchisees on an annual basis;

E. any change in the franchise fees charged by the franchisor; or

F. any significant change in:

(1) the obligations of the franchisee to purchase items from the franchisor or its designated sources;

(2) the limitations or restrictions on the goods and services which the franchisee may offer to its customers;

(3) the obligations to be performed by the franchisor; or

(4) the franchise contract or agreement, including all amendments thereto.[30]

3. **Financial Assurances**

Many franchise examiners will review the franchisor's financial statements carefully to determine whether the franchisor has sufficient assets (including current assets) and net worth to perform the obligations and services promised to franchisees. In these states, emerging franchisors may have an additional hurdle to registration of their franchise offering – the requirement of a financial assurance due to the franchisor's financial condition. In the authors' experience, more and more registration states are requiring these financial assurances for startup and emerging franchisors due to their financial condition or simply due to their lack of operating history. Unfortunately, there is no "magic" minimum net worth that is acceptable to all state regulators which would allow the franchisor to avoid a financial assurance requirement. Startup and emerging franchisors in particular will experience wide variation across the registration states in how their audited financial statements are judged.

Some state statutes and regulations do not provide details on how the franchise examiner determines the adequacy of the franchisor's financial resources;[31] however, state examiners may focus on all or some of the following measures in their review of the franchisor's financial

[30] MINN. R. 2860.2400A.-F.

[31] For example, Section 14-217 of the Maryland Franchise Registration and Disclosure Law allows the state to impose a financial assurance condition if the state franchise administrator "finds that it is necessary and appropriate for the protection of prospective franchisees . . . because a franchisor has not made adequate financial arrangements to fulfill the franchisor's obligations under an offering." MD. CODE. ANN., BUS. REG. § 14-217(a).

statements: cash flow, current and quick ratios, net worth, and net income analysis.[32] Franchise examiners also will consider the number of projected franchise openings disclosed in Item 20, Table No. 5, and the franchisor's estimated costs in providing pre-opening services listed in the franchisor's Costs and Source of Funds submitted with its application. Illinois spells out the minimum financial tests that it applies.[33] In Washington, a startup franchisor's limited operating history – while not dispositive – weighs heavily on a regulator's analysis, and may result in a financial assurance condition despite a strong opening audited balance sheet or net worth.

Franchisors that show a negative or insufficient net worth in their audited financials are often subject to financial assurance requirements imposed by state franchise examiners in certain franchise registration states, as well as additional questions from franchisee prospects regarding the strength of their system. The adoption of ASC 606 revenue recognition standards by the Financial Accounting Standards Board ("FASB") may affect a franchisor's financial statements due to adjustments in the franchisor's net worth. Historically, franchisors have been allowed to immediately recognize initial franchise fees earned from incoming franchisees when all material services or conditions relating to the sale have been substantially performed or satisfied. For developing brands, the recognition of this income can be critical to the financial stability of a franchisor beginning to grow their system. Now, private companies are required to comply with FASB's ASC 606 revenue recognition standards, requiring franchisors to amortize their initial fees over the life of the franchise term.[34] Recognizing the problem this would create for franchisors, FASB introduced the idea of recognizing revenue in a different manner called "practical expedient". The practical expedient allows a franchisor, that is not a public company, to recognize revenue from the initial franchise fee *immediately* by taking into account certain pre-opening services provided to the franchisee as a single performance obligation.[35] The FASB recently voted to finalize the proposed practical expedient related to franchisors, so that this new method of recognizing franchise fee revenue could be recognized. Franchisors that are still emerging, and especially those that had a fast launch with exponential sales in their first year or two, should discuss the practical expedient and ASC 606 with their accountant and lawyer in advance of state

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[32] *See* Christina M. Noyes & Peter H. Dosik, *Oh No, Is That Really a Material Change? Disclosure, Exemption and Registration Issues in Challenging Economic Times*, INT'L FRANCHISE ASS'N. 44TH ANNUAL LEGAL SYMP., at 28-30 (2011) (detailing the process that various states use to review the franchisor's financial condition, as well as the requirements of escrow, fee deferral, and surety bonds).

[33] ILL. ADMIN. CODE tit. 14, § 200.500(b) ("When determining whether adequate financial resources are available, the Administrator shall give consideration to the applicant's recent financial statements. The following criteria shall be considered in making the determination: the auditor's opinion letter or review report, notes to the financial statements, the current ratio, the quick ratio, the amount of working capital, the proportion of tangible and intangible assets, the amount and maturities of debts, the debt/equity ratio, the amount of equity, the earnings history, the proportion of receivables compared to other assets, and the quality of receivables, e.g. financial statements reflect receivables that will not be collected, including bad debts, a debt discharged in bankruptcy, or the failure to allow for aged receivables.").

[34] For example, if a franchisor received $40,000 from a new franchisee who had signed a 10-year franchise agreement, the franchisor would have to amortize the fee over the 10-year term, providing the brand with only $4,000 in recognized revenue per year.

[35] The predefined list of pre-opening services includes: assistance in the selection of a site; assistance in obtaining facilities and preparing the facilities for their intended use, including related financing, architectural, and engineering services, and lease negotiation; training of the franchisee's personnel or the franchisee; preparation and distribution of manuals and similar material concerning operations, administration, and record keeping; bookkeeping, information technology, and advisory services, including setting up the franchisee's records and advising the franchisee about income, real estate, and other taxes or about local regulations affecting the franchisee's business; and inspection, testing, and other quality control programs.

registration.

Despite how the franchise fee is ultimately recognized for the emerging franchisor, after the financial statements are prepared and included within the FDD, if the state examiner determines that the franchisor is inadequately capitalized or has a negative net worth,[36] he or she may determine that the franchisor must provide "financial assurances" and require the franchisor to either:

- defer initial fees;[37]
- deposit initial franchisee fees and other funds collected from franchisees before the franchisor has satisfied its pre-opening obligations into an escrow account with a bank authorized to do business in the state; or
- post a surety bond with a bank authorized to do business in the state.[38]

A franchisor also may be able to satisfy the financial assurances condition by using audited financial statements from a parent or affiliate with a stronger financial condition (and that provides a guaranty of the franchisor's obligations) or a capital infusion in an amount acceptable to the franchise examiner.[39] States generally permit the franchisor to choose among the options for complying with the escrow/impound condition and may permit the franchisor to use more than one option, such as escrows or impounds for new franchised outlets, and fee deferrals for conversion or transfers.

The following table summarizes the advantages and disadvantages of each method for providing financial assurances:

Financial Assurance	Advantages	Disadvantages
Defer Initial Fees	• Time • Free (with respect to costs for implementation) • Low administrative burden	• Deferred payment • Financial uncertainty • Other deferred costs

[36] In addition, Maryland and Washington generally require financial assurances for startup franchisors or "development companies," regardless of the financial indicators on the balance sheet. *See* Dale Cantone, Martin Cordell, Warren Lee Lewis & Felicia N. Soler, *Is Your System Compliant? Recent Changes and Hot Issues in Federal and State Franchise Regulation*, ABA 34TH ANNUAL FORUM ON FRANCHISING W-18, at 40 (2015).

[37] State franchise examiners or applicable state law may permit the franchisor to comply with an escrow condition by deferring fees if requested. As a practical matter, the fee deferral is by far the most popular choice due to its simplicity and lack of an upfront cost.

[38] S*ee* C. Christian Thompson, Kara K. Martin, Nate Whitaker & Heidi Coccimiglio, *Bonding: What It Is and How to Do It*, 20 THE FRANCHISE LAW. 4, at 12-14 (2017) (providing a detailed analysis of state surety bond requirements).

[39] Infusing capital only works if the loan is long term (*i.e*., the lender may not call the loan until after the end of the current registration year), a subsequent event note addressing the loan is added to the most recent audited financial statement, and the franchisor uses the capital in the ordinary course of doing business and does not withdraw the capital immediately after the audit. Some states, including Washington, do not accept an additional capital infusion as an acceptable financial assurance.

Financial Assurance	Advantages	Disadvantages
Summary of Deferral	No need to set up bank accounts, file additional paperwork, or request a release of funds from regulators. Simply collect the fees later, once the franchisee is open for business and all pre-opening obligations of the franchisor are complete.	As the initial fees cannot be collected until after the franchisee commences operations, the franchisor will have to perform its pre-opening obligations to franchisee before collecting any fees which would offset the cost of those obligations. Down the line the franchisee may not open or pay initial fees, and the franchisor may incur legal and administrative costs in default, termination, and collections.
Escrow Initial Fees	• Financial certainty • Low expense	• Deferred payment • Time • Control • Administrative burden • Administrative costs
Summary of Escrow	As the franchisee still must pay the initial fees up front, the money will be there once the franchisee has opened. Initial expenses in setting up the escrow account are typically less than a surety bond account.	The franchisor must use a bank that meets certain state requirements, establish an escrow account, and maintain that account. The franchisor must then seek release of the funds by state examiners by providing documentation that it has met its pre-opening obligations.
Surety Bond	• Immediate payment • Lower administrative burden	• Time • High cost • Administrative burden • Some control
Summary of Surety Bond	The franchisor may collect fees as it normally would. Lower administrative burden than escrow of initial fees.	It will take time to find the appropriate issuer which offers the bonds required by the different states. The costs of maintaining the bond are usually higher (typically 1% of the bond amount per year). The bond amount is set by the state, and the release of the bond requires state permission.

4. Exemptions/Exclusions

The franchise registration states, along with the FTC Franchise Rule, have exemptions or exclusions from their registration and/or disclosure requirements. While the scope and applicability of these exemptions and exclusions is beyond the scope of this article,[40] a few may be useful to a startup or emerging franchisor (specifically, the large franchisee, large investment,

[40] For state-by-state and federal review of each exemption and exclusions, *see generally* EXEMPTIONS AND EXCLUSIONS UNDER FEDERAL AND STATE FRANCHISE REGISTRATION AND DISCLOSURE LAWS (Leslie D. Curran and Beta Krakus eds., 2017). *See also* Karen Satterlee & Stephanie Zosak, Fundamentals 201: Use of Franchise Law Exemptions, ABA 45TH ANNUAL FORUM ON FRANCHISING W-16 (2022).

and isolated sales exemptions, if available in a particular state). However, in most cases it is unlikely that an emerging franchisor can rely on exemptions or exclusions in all states, a smaller franchisor that only offers franchises in a limited number of states should determine whether any of these exemptions or exclusions apply. Even if an exemption from both registration and disclosure applies at the state level, the FTC Franchise Rule's disclosure obligations must still be followed unless a federal disclosure exemption also applies.

IV. DEVELOPING A COMPLIANCE PROGRAM

A. Franchisor Compliance

Emerging franchisors are often surprised to find out how time consuming it is to operate a franchise system, especially if the system is growing. Successful franchisors spend significant time finding and qualifying prospective franchisees, ensuring that proper disclosures were made and the agreements were properly executed, all before a franchisee starts the onboarding and training process.[41]

1. Franchise Sales Compliance

Typically a startup franchisor focuses its initial sales on leads it may have had before it started franchising – sometimes these are existing employees at a company-owned outlet, friends and family, or customers or patrons who may have reached out wanting to open their own franchised outlet. At this beginning stage, many startup franchisors do not have a robust or even written sales compliance program. As the franchisor grows, proper franchise sales compliance becomes even more important. As emerging franchisors find out, failure to follow proper sales procedures not only exposes the franchisor to legal claims, but may also invite franchisees into the system who end up not being a good fit or successful operators. For an emerging brand, a significant proportion of these underperforming operators – for whatever reason – can be fatal to the system as a whole.

As the system grows, the franchisor will often need to hire internal sales personnel to support the sales, marketing, and onboarding of franchisees. It may also retain third-party franchise brokers or sellers to find prospects. In either case, the franchisor should establish minimum franchisee qualifications, structure franchise sales compliance procedures and training programs, and appoint a franchise compliance manager or director. Most emerging franchisors simply use spreadsheets and checklists designed by the franchisor, before upgrading to more sophisticated software programs available from third parties. Regardless of the procedures and format of the sales compliance program, the franchisor must have a system to document and track the franchisor's compliance with franchise laws and other legal requirements, such as FDD delivery, receipts, waiting periods, FDD versions, and negotiated changes.[42] A franchise compliance program should address maintaining written records to help a franchisor disprove any future claims that a franchise sale was legally non-compliant.[43] Establishing strong sales

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[41] For more on this topic, see Cheryl Lucente, Sawan Patel, & Leslie Pujo, *A Practical Guide to Managing Issues Faced by Start-Up and Small Franchisors*, INT'L FRANCHISE ASS'N 51ST ANNUAL LEGAL SYMP. (2018).

[42] *See* Debra A. Harrison & David W. Koch, *The Evolving Franchise System: How to Guide an Emerging System from "Baby Steps" to a "Grown-Up" System*, INT'L FRANCHISE ASS'N 43RD ANNUAL LEGAL SYMP., at 8 (2010).

[43] A non-compliant franchise sale occurs, for instance, when the franchisor fails to provide full or timely disclosure; fails to update the FDD after a material change has occurred; makes unauthorized financial performance representations;

programs and procedures from the outset will place the franchisor in the best position to attract qualified franchisees who will represent the brand well in the long-term.

Startup franchisors may be tempted to quickly close deals without carefully evaluating prospective franchisees. Failure to establish minimum qualifications and objective evaluation criteria for new franchisees, however, may lead to franchisees with unrealistic expectations, inadequate experience or capitalization, or personality to successfully operate an outlet under the franchisor's brand and culture.[44] Requiring franchisees to meet minimum experience and financial thresholds or other *objective* background and business compliance requirements may also protect franchisors from allegations of discrimination in the sales process.[45]

Most franchisors establish minimum net worth requirements, minimum liquid cash requirements, minimum business experience requirements, and requirements regarding past litigation and bankruptcies. Additional qualifications may also be appropriate based on the business model. These minimum qualifications should be listed in an application designed to gather the information necessary to evaluate whether the prospective franchisee meets the threshold. In addition to these basic questions, franchisors should also obtain the following from prospective franchisees:[46]

- Information about ownership structure and copies of organization documents for entity applicants (including certified articles, bylaws/operating agreements, and good standing certificates);
- Balance sheet (for both entities and their individual owners);
- Information about operational experience in the same industry as the franchised business and other business experience;
- Business and personal references;
- Information about the operation or ownership of competing businesses;
- USA Patriot Act representations (and compliance check by the franchisor); and
- Credit and background check.

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or offers or sells franchises without registration (or an exemption) in franchise registration states. For a discussion of pre-sale disclosure mistakes *see* Joseph J. Craciun & Andraya C. Frith, *To Err is Human: Remedying Mistakes in the Pre-Sale Disclosure Process*, INT'L FRANCHISE ASS'N 44TH ANNUAL LEGAL SYMP. (2011).

[44] *See* Steven J. Vaughan, Mark Robertson & Nikki Gahr Sells, *Facing the Music before the Band Plays: Protecting the Franchise System Entrance with Franchisee Qualification Criteria*, INT'L FRANCHISE ASS'N 42ND ANNUAL LEGAL SYMP. (2009) (providing detailed recommendations of the franchise application process and evaluation of prospective new franchisees); *see also* Greg Nathan, *Engineering Healthy Franchise Relationship*, ABA 32ND ANNUAL FORUM ON FRANCHISING P-1, at 21 (2009).

[45] *See* Elbanna v. Captain D's LLC, No. 3:07-cv-926-J-32MCR, 2009 WL 435-51, at *9-14 (M.D. Fla. Feb. 17, 2009) (finding no evidence that franchisor's disapproval of prospective franchisee was based on race when franchisor asserted two legitimate non-discriminatory bases for rejection: failure to meet financial liquidity requirements and deficient operations at outlets operated by the prospective franchisee in another franchise system).

[46] Vaughan, et al., *supra* note 44, at 14-26.

However, an application is only as good as the process. That is, the franchisor must apply evaluation criteria consistently and avoid the temptation to relax or waive standards for certain candidates.

At the end of any franchise sale, emerging franchisors should consider requiring that all prospective franchisees complete and sign a "compliance questionnaire" or "disclosure acknowledgment statement" before signing the Franchise Agreement. This questionnaire must be included as an exhibit to the FDD.[47] Completing these questionnaires may help the franchisor identify and resolve potential legal issues before a deal is closed (or in extreme cases, cancel a deal altogether). Note that these questionnaires are being more frequently reviewed by state franchise examiners to ensure that franchisees are not disclaiming any representations under the FDD or state law.[48] Some states, including Washington, will require additional language on the questionnaire. A sample Compliance Questionnaire/Disclosure Acknowledgment Statement is attached as Appendix A.

2. Internal Franchise Sales Training Programs

If an emerging franchisor is utilizing an outside sale broker or if the franchisor is having its own internal team find and award franchises to prospective franchisees, in order to ensure that all personnel involved in the sales process follow the franchisor's procedures, the franchisor will eventually need to provide internal sales training. The franchisor may choose to participate in a sales compliance training program offered by a third party (such as a trade association) or create a custom training program with the assistance of franchise counsel. This training should address, at a minimum:

- A "culture of compliance";
- An overview of franchising laws (including penalties for non-compliance);
- An item-by-item overview of the FDD, including
    - General requirements,
    - Franchisor-specific disclosures, and
    - An overview of agreements and other exhibits included in the FDD;
- Financial performance representations;
- Disclosure obligations, including
    - Waiting periods,
    - Format of FDD disclosure, and
    - Receipts and franchise sellers;

[47] 16 C.F.R. § 436.5(v).

[48] *See* N. AM. SEC. ADM'R ASS'N, REQUEST FOR PUBLIC COMMENT: PROPOSED STATEMENT OF POLICY REGARDING THE USE OF FRANCHISE QUESTIONNAIRES AND ACKNOWLEDGEMENTS (Dec. 6, 2021) https://www.nasaa.org/wp-content/uploads/2021/12/Request-for-Public-Comment-SOP-on-Franchise-Questionnaires-12-6-2021.pdf (NASAA is currently reviewing acknowledgments and questionnaires).

- Recordkeeping and ongoing registration, including

    - Advertising requirements (and state filing requirements),
    - Material changes and amendments, and
    - Quarterly and annual amendments; and

- State franchise relationship laws.

a. <u>FDD Receipts</u>

Each prospective franchisee who receives an FDD should be required to sign and return to the franchisor the last page of the FDD (the "Receipt Page"), acknowledging he or she received a copy of the FDD.[49] Franchisors must keep the Receipt Page in their files, whether or not the prospect purchases a franchise, for at least three years.[50] If the prospect purchases a franchise, the franchisor should retain the Receipt Page for so long as the franchise agreement remains in effect, plus at least six years (based on the typical statute of limitations for contractual claims). Emerging franchisors unfortunately often fail to properly complete these Receipt Pages or obtain signed Receipt Pages from prospects.

The form of Receipt Page included in most FDDs includes a blank space for the name of the "franchise seller."[51] The "franchise seller" is the person who offers for sale, sells, or arranges for the sale of the franchise, which "includes the franchisor and the franchisor's employees, representatives, agents . . . and third-party brokers."[52] Franchisors must complete this information with the name, business address, and telephone number of all people involved in each specific sale.[53]

It is likely that emerging franchisors add franchise sellers as they evolve and grow, whether employees or third-party sellers, brokers, or consultants. As the franchisor adds franchise sellers, it should consult with legal counsel regarding filing requirements in certain franchise registration states – this requirement is separate and above the requirement of filing the FDD and registering the franchise offering. Specifically, franchisors are required to file in certain franchise registration

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[49] 16 C.F.R. § 436.5(w), *see also* FTC COMPLIANCE GUIDE, *supra* note 20, at 117.

[50] 16 C.F.R. § 436.6(i); FTC COMPLIANCE GUIDE, *supra* note 20, at 117.

[51] 16 C.F.R. § 436.5(w).

[52] 16 C.F.R. § 436.1(j) (franchise sellers include the employees of the franchisor, not just third-party sellers, brokers, or consultants). *See* Eleanor Vaida Gerhards, Allan Hillman & Gerald C. Wells, *The Latest on Working with Franchise Sales Organizations, Agents and Brokers*, 45TH ANNUAL FORUM ON FRANCHISING W-22 (2022); *see also* Nathan, *supra* note 44, at 21; Donna Christopherson, Marc Kiekenapp & Joel Siegel, *Broker Liability: Minimizing the Business and Legal Risks Associated with Brokers and Other Third Parties*, INT'L FRANCHISE ASS'N 40TH ANNUAL LEGAL SYMP. (2007).

[53] FTC, *Frequently Asked Questions No. 12* (Dec. 2013), https://www.ftc.gov/tips-advice/business-center/guidance/amended-franchise-rule-faqs (last visited Aug. 25, 2022) (if the franchisor knows which franchise seller was involved in the sale when it discloses the prospect with the FDD, the franchisor can complete this information before it discloses the prospect. Otherwise, the information can be inserted at a later date. Of course, that raises a question: how can someone acknowledge receipt of the FDD as soon as they receive it, if the blank space has not been completed? The Federal Trade Commission has concluded that a franchisor can obtain a signed Receipt before the blank space has been completed, so long as it subsequently inserts the missing information, and so long as it does so before the prospect signs any Franchise Agreement or Area Development Agreement or pays the franchisor or any affiliate any money. The franchisor must keep a copy of the form of Receipt that includes the name, business address, and telephone number of the franchise seller).

states a Franchise Seller Disclosure Form for each person who will be involved in the sale of franchises, before they may engage as a franchise seller on behalf of the franchisor. It is therefore important that if during the year a franchisor adds additional sales brokers to the sales process, that they file Franchise Seller Disclosure Forms for them in these registration states. Further, New York and Washington require that any third-party sellers complete a separate "broker registration" in the applicable state before beginning to offer or sell franchises on the franchisor's behalf in that state.[54]

b. Franchisor Certificates in Canada

Canadian provincial franchise disclosure legislation requires that every disclosure document delivered contain a certificate in the prescribed form certifying that the document contains no untrue information, representations, or statements, and includes every material fact, financial statement, and other information required by the legislation.[55] If the franchisor is a corporate entity, the franchisor certificate must be signed and dated by at least two officers or directors, or by the sole officer or director if the corporation has only one director and officer.[56] If the franchisor is an unincorporated entity, the certificate must be signed and dated by the franchisor.[57] Franchisees have a statutory right of action against every person who signed the franchisor's certificate for any misrepresentations contained in the disclosure document.[58]

It is important to note that Canadian courts have consistently held that failure to include the mandatory and properly executed franchisor certificate is a fatal flaw giving rise to the full two-year statutory rescission remedy even where the disclosure document is otherwise compliant.[59] Given the significance of a properly executed certificate, the emerging franchisor should be counselled to have internal processes to ensure every disclosure document contains the necessary franchisor certificate and record retention practices that will enable the franchisor to produce a full copy of the complete disclosure document provided to a particular candidate, including the signed and dated franchisor certificate.

c. Waiting Period

Under the FTC Franchise Rule, a franchisor must give the FDD to a prospective franchisee at least fourteen calendar days before the prospect signs a binding agreement with, or makes a

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[54] Gerhards, et al., *supra* note 52.

[55] O. Reg. 581/00, § 7 (Ontario); N.B. Reg. 2010-92. § 6 (New Brunswick); P.E.I. Reg.F-14.1. § 4(1) (Prince Edward Island); M. Reg. 29/2012. §2(3) (Manitoba); B.C. Reg. 238/2016. § 7 (British Columbia); A. Reg. 240/95, § 2(3) (Alberta).

[56] *Id*.

[57] *Id.*

[58] Arthur Wishart Act (Franchise Disclosure), 2000, S.O. 2000, c. 3, s. 7(1)(e) – (Ontario); Franchises Act, S.B.C. 2015, c. 35, s. 7(1)(d) – (British Columbia); Franchises Act, S.M. 2010, c. 13, s. 7(1)(d) – (Manitoba); The Franchises Act, S.N.B. 2007, c. F-23.5, s. 7(1)(d) – (New Brunswick); Franchises Act, S.P.E.I. 2005, c. 36, s. 7(1)(d) – (Prince Edward Island); S.A. 2000, c. F-23, s. 9(1)(b) – (Alberta).

[59] Hi Hotel Ltd. P'ship v. Holiday Hospitality Franchising Inc., 2007 ABQB 686, *aff'd,* 2008 ABCA 276 (Can.); Mendoza v. Active Tire & Auto Ctr. Inc., 2016 ONSC 2009, *rev'd*, 2017 ONCA 471 (Can.); 248308 Ontario Inc. v. 2082100 Ontario Inc., 2020 ONSC 475, *aff'd*, 2022 ONCA 453 (Can.).

payment to, the franchisor or an affiliate in connection with the proposed franchise sale.[60] The prospect must have the FDD in their hands for a full fourteen days such that the agreement should not be signed, or consideration paid, until the fifteenth day following delivery of the FDD. Thus, if the franchisor gives a prospect the FDD on October 1st, the franchise agreement should not be signed (or consideration paid) until October 16th at the earliest. The date on the signed Receipt Page should be used to start the waiting period.

In addition – and irrespective of the state in which the franchisor is selling franchises – the franchisor must wait an additional seven calendar days from the time it presents the prospect with execution copies of the agreements (all blanks filled in) before the prospect can sign the agreement or pay the franchisor or any affiliate any money. However, under the FTC Franchise Rule, if changes are made at the request of the prospect (even if there are trade-offs and some of the changes are favorable to the franchisor), no additional seven-day waiting period is required prior to signing (assuming the appropriate time period has passed since the franchisor originally disclosed the prospect with the FDD).[61]

The fourteen-day waiting period and the seven-day waiting period can run simultaneously; however, if a franchisor discloses the form FDD (with blanks) first and later discloses the completed franchise agreement (with all blanks filled in), it will need to make sure that both the fourteen-day and seven-day waiting periods expire before the prospect signs any binding agreement or pays any money to the franchisor or its affiliate.

The FTC Franchise Rule also provides guidance on when the FDD is deemed "delivered" (for purposes of starting the fourteen-day and seven-day waiting periods). If a franchisor hand delivers, faxes, or emails the document to prospects, it is deemed delivered on the date that the franchisor takes any of those actions.[62] If a franchisor provides the document by giving directions for accessing it on the Internet, it is deemed delivered on the date the franchisor provides directions for access.[63] If a franchisor mails a paper copy or CD-ROM, it is deemed to be delivered on the third calendar day after the franchisor sends it by first-class mail.[64]

Under Canadian franchise legislation, unless one of the limited exemptions is available, the franchisor must provide a prospective franchisee (including new, renewing, and resale franchisees) with the disclosure document (with all required information contained in one document and delivered at one time) at least fourteen days before the earlier of:

> (a) the signing by the franchisee of the franchise agreement or (subject to certain exceptions in Ontario, Alberta, PEI, New

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[60] 16 C.F.R. § 436.2. There are a few states that have additional rules regarding the timing of disclosure. In Iowa, a franchisor must provide the FDD to prospects at least fourteen calendar days before the prospect signs a binding agreement with, or makes a payment to, the franchisor or an affiliate in connection with the proposed franchise sale, or the date of the first personal face-to-face meeting, whichever is earlier. There are also special delivery and/or timing requirements in Michigan and New York. The requirements for these states are often noted on the Receipt Pages of the FDD.

[61] *Id.*

[62] 16 C.F.R. § 436.2(c)(1).

[63] *Id*. § 436.2(c)(2).

[64] *Id*. § 436.2(c)(3).

Brunswick, Manitoba, and British Columbia) any other agreement relating to the franchise; and

(b) the payment of any consideration relating to the franchise (though deposits are permitted, subject to certain requirements, in Ontario, Alberta, Manitoba, and British Columbia).[65]

Note that the term "franchise agreement" is broadly defined under Canadian provincial franchise disclosure legislation to include *any* agreement between a franchisor or a "franchisor's associate" and a franchisee or prospective franchisee, subject to certain limited exceptions in the Acts.

The fourteen-day waiting period must be calculated in accordance with the applicable provincial Interpretation Act. In Ontario and New Brunswick, the fourteen-day waiting period excludes the day on which the prospective franchisee receives the disclosure document, effectively making the disclosure period fifteen days.[66] In Alberta, PEI, Manitoba, and British Columbia, both the day on which the disclosure document is received as well as the day on which a franchise agreement is signed or payment is made are excluded from the calculation, effectively making the waiting period sixteen days.[67] Failure to honor the mandatory waiting period under applicable provincial franchise disclosure legislation provides the franchisee with the right to rescind the franchise agreement for up to sixty days after receiving the disclosure document.[68]

d. Negotiating Changes with Franchisees

During the sales process, it is inevitable that some franchisees will ask the franchisor to make changes to the franchise agreement or other agreements. This is much more common for smaller or emerging franchise systems, as larger franchisors often offer their agreements on a "take-it-or-leave-it" basis. While it is certainly tempting to entertain these negotiations and changes, especially for a smaller franchisor looking to close its initial sales, in most cases the emerging franchisor should refrain from engaging in significant negotiations to the franchise agreement (except where needed to address a particular situation or market).

An important purpose of a uniform FDD is to assure that one franchisee is not treated better than another simply because he or she is a better negotiator. There are therefore certain provisions in the FDD that would have to be changed to indicate that a franchisor negotiated

[65] Arthur Wishart Act (Franchise Disclosure), 2000, S.O. 2000, c. 3, s. 5(1) – (Ontario); Franchises Act, S.B.C. 2015, c. 35, s. 5(1) – (British Columbia); Franchises Act, S.M. 2010, c. 13, s. 5(2) – (Manitoba); The Franchises Act, S.N.B. 2007, c. F-23.5, s. 5(1) – (New Brunswick); Franchises Act, S.P.E.I. 2005, c. 36, s. 5(1) – (Prince Edward Island); S.A. 2000, c. F-23, s. 4(2) – (Alberta).

[66] Legislation Act, S.O. 2006, c. 21, s. 89(3) – (Ontario); Interpretation Act, S.N.B. 1973, c. I-13, s. 22(k) – (New Brunswick).

[67] Interpretation Act, R.S.A. 2000, c. I-8, s. 22(6) and s. 22(7) – (Alberta); Interpretation Act, S.P.E.I , c. I-8, s. 23(4) – (Prince Edward Island); The Interpretation Act, S.M., c. 180, s. 22(3) – (Manitoba); S.B.C. 1996, c. 238, s. 25.2(2) – (British Columbia).

[68] Arthur Wishart Act (Franchise Disclosure), 2000, S.O. 2000, c. 3, s. 6(1) – (Ontario); Franchises Act, S.B.C. 2015, c. 35, s. 6(1) – (British Columbia); Franchises Act, S.M. 2010, c. 13, s. 6(1) – (Manitoba); The Franchises Act, S.N.B. 2007, c. F-23.5, s. 6(1) – (New Brunswick); Franchises Act, S.P.E.I. 2005, c. 36, s. 6(1) – (Prince Edward Island).

changes with respect to those matters if it did, in fact, make changes in the past.[69] Obviously, once a franchisor makes that disclosure, subsequent franchisees may use that disclosure to negotiate their franchise agreement. Even outside of these FDD disclosure obligations, especially in smaller franchise systems, it is likely that franchisees will talk to each other and one may find out that the franchisor offered a better deal to another franchisee. In addition, in the authors' experience, when significant changes are made and different franchisees have different or unique terms, enforcement becomes more difficult. The fact is that a franchisor will not remember what changes it made for each franchisee, and it will not want to look at the agreement every time an issue arises.

The foregoing is not to say that a franchisor cannot agree to make changes to any provisions in the franchise agreement or other agreements. For example, it is not uncommon for a franchisor to agree to reduce the initial franchise fee, extend an opening deadline, provide a ramp-up period for royalties (especially those not based on gross sales), grant territorial exceptions, or limit the guarantors' obligations. Unfortunately, new franchisors frequently are involved in more negotiations. The above is simply a caution to emerging franchisors to be very careful, as the authors have seen some franchisors make changes in one agreement that will affect the terms of the agreements they subsequently sign with other franchisees.[70] Hopefully, any agreed-upon changes will be only made to "non-material" provisions to address specific situations or market areas.

Typically, negotiated changes are documented in an amendment or addendum to the franchise agreement rather than in the agreement itself. This is for the simple reason that using a separate amendment makes it much easier to quickly identify which franchisees have specially-negotiated changes without having to fully review each executed franchise agreement against the relevant form. For operational and financial reasons, it is important for a franchisor to track which specific franchisees have material modifications or negotiated changes.

3. Encroachment and Territorial Rights

In the early stages of development, the franchisor and its franchisees often work together to expand the brand into new markets. As the system grows, and additional locations (whether franchised or company-owned) are developed in the same market, the franchisor granting additional franchise rights or opening its own locations in that market could appear threatening to existing franchisees through the concept of encroachment.[71] This threat may be magnified in situations where one or more initial franchisees were instrumental in developing a new market. In the franchising context, the term "encroachment" may be used to describe the act of a franchisor placing a new franchise or company-owned outlet of the same type near an existing franchise or outlet.[72] However, the concept can arise in almost any new franchisor venture – from granting a franchise in a nearby non-traditional venue serving a captive audience, such as an airport or

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[69] For example, Item 5 requires the disclose of any variations to the initial franchise fees in the prior year. 16 C.F.R. § 436.5(e). In addition, the California Franchise Investment Law imposes additional disclosure, registration renewal, and recordkeeping obligations upon franchisors regarding "each material negotiated term that was negotiated by the franchisor for a California franchise." CAL. CORP. CODE § 31109.1.

[70] For example, if a franchisor makes an agreement with one franchisee that all advertising contributions will be spent in the territories in which they are received, it has now limited its use of advertising funds for the term of that agreement.

[71] *See* Robert W. Emerson, *Franchise Encroachment*, 47 AM. BUS. L.J. 191, 201-05 (2010).

[72] *Id.* at 192-201.

stadium or event venue, to selling similar products in grocery stores, or even permitting other franchisees to perform services over the internet.[73]

A franchisor must not only be cognizant of what territories and rights it has granted to its franchisees, but also what rights it has reserved for its own exploitation.[74] Franchisors usually prevail in encroachment disputes where the contract expressly and clearly reserves to the franchisor the right to open or franchise another location, or to sell its products in the franchisee's area or anywhere other than at the franchisee's specific protected territory.[75] It can be difficult to know exactly what future rights are important to reserve while a business is in the early stages of growth. However, it is recommended to be as specific and inclusive in drafting a reservation of rights not granted to the franchisee.[76] Although some franchisors are comfortable in simply delineating the franchisee's protected rights only, without specifically listing rights reserved for the franchisor, others take a more cautious approach. In the latter case, these franchisors will list in Item 12 and in the Franchise Agreements the specific rights reserved for each party. For example:

> As long as you are in compliance with your Franchise Agreement and any other agreements with us and any of our affiliates, we will not operate, or permit another franchisee to operate, a [Franchised Business] under the [trademark] mark that provides [description of products or services offered] from a site physically located in your [Protected Territory]. Other than this limitation there are no other prohibitions on us in your [Protected Territory] or elsewhere. We and our affiliates can, and we can permit third parties to, operate their [trademark] businesses outside your [Protected Territory]. Other franchisees or [trademark] businesses we or our affiliates own may solicit or serve the same customers that you serve, so long as they are not providing [description of products or services offered] to customers from a site physically located in your [Protected Territory]. We can operate or allow others to operate similar or identical business outside of your [Protected Territory] under the [trademark] mark or under any other trademarks even if the businesses compete with your [Franchised Business] in your [Protected Territory]. We can also operate or allow others to operate businesses inside the [Protected Territory] under any marks, including the [trademark] mark, if the businesses do not provide [description of products or services offered]. We can sell, or grant third parties the right to sell, any products we or our affiliates provide to you for use in your [Franchised Business] to any person, whether in or outside your [Protected Territory]. We can also sell, or grant

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[73] *Id.* at 214-28.

[74] *See* Kenneth F. Darrow, Mark Siebert & Phyllis Alden Truby, *The Structural Elements of a Franchise System and Their Economic and Legal Implications for Start-Up and Existing Systems*, ABA 30TH ANNUAL FORUM ON FRANCHISING W-2, at 31-35 (2007) (providing information on the factors involved in setting a territory).

[75] *See generally* Charles S. Marion, Daniel J. Oates & Ari N. Stern, *Stepping on Toes: Territorial Rights and Encroachment*, ABA 42ND ANNUAL FORUM ON FRANCHISING W-14 (2019); *see also* Meaney & Schott, *supra* note 1, at 16-17.

[76] *See* Meaney & Schott, *supra* note 1, at 16-17.

> third parties the right to sell, goods or services competitive with those sold or used by your [Franchised Business] under the [trademark] mark or otherwise through other distribution channels including the Internet, catalog sales, telemarketing, or other direct marketing, inside and outside of your [Protected Territory]. We can market and sell products and services, including those competitive to the products and services provided through your [Franchised Business], to national, regional, and institutional accounts, whether located inside or outside your [Protected Territory]. We can acquire businesses in the [Protected Territory] that are similar to your [Franchised Business] or sell our business, whether through a sale of assets or stock, to anyone, regardless whether they operate or franchise the operation of businesses similar to your [Franchised Business].

Franchisee claims of encroachment also can arise when a franchisor acquires or merges with another franchise chain, so that the franchisor suddenly owns or franchises locations of the acquired chain that compete with its existing franchisees.[77] In a merger or acquisition situation, the complaint of encroachment may come from the franchisor's newly-acquired franchisees as well as existing franchisees.

Notwithstanding the franchisor's reserved territorial rights, discussed above, emerging franchisors must still develop more advanced ways of assessing potential encroachment, such as through an impact analysis. This is especially true as the franchisor grows and begins having more franchises in a single market. Emerging franchisors should consider ways of measuring what a market size is in which a franchised business can operate without cannibalization from other outlets. Thus, even if the franchisor can, legally, put a nearby outlet does not mean it should from a business perspective. Emerging franchisors should not be short-sighted to increase immediate revenue at the expense of unnecessary strain on the system and angering franchisees.

Beyond drafting strong territorial provisions, it is essential that the franchisor builds territory tracking and maintenance into its compliance programs.[78] For a franchisor in the early stages of development, it is not uncommon to want to make changes to the territory protections provided to franchisees. Before doing so, a franchisor will want to ensure that such changes will not result in franchisees receiving conflicting territorial protections. Similarly, a franchisor that has gone through an acquisition or merger with another franchise system is likely to have a patchwork of different legacy rights and territories. A compliance system is paramount to understand if some new venture will run afoul of the agreements already in place and aid the franchisor in avoiding any potential claims for encroachment.[79] Unfortunately, it is not uncommon for small, startup franchisors to struggle with tracking territorial rights unless either they have a small number of franchises in geographically distinct markets, or employ third-party software.

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[77] Charles S. Modell & Sherin Sakr, *Competing Brands Under Common Ownership*, ABA 37TH ANNUAL FORUM ON FRANCHISING W-19, at 9-13 (2014).

[78] *See generally* Susan Grueneberg & Dawn Newton, *Best Practices for Establishing a Franchise Compliance Program*, ABA 33RD ANNUAL FORUM ON FRANCHISING W-19 (2010).

[79] One common practice some franchisors use to determine positional encroachment is a competitive impact analysis. *See* Marion, et al., *supra* note 75, at 31-36.

B. Monitoring Franchisee Compliance with Agreement Terms and Operating Standards

As the system grows in size and geographic footprint, so too grows the number of franchisees who may be experiencing operational challenges or who may be in default of their obligations under the franchise agreement. The emerging franchisor will need to invest in additional resources to provide ongoing operational support and training to franchisees and to monitor the franchisees' compliance with operating standards, including through regular on-site visits and by leveraging technology to conduct more frequent remote check-ins with franchisees, particularly where franchisees are visibly struggling or underperforming relative to the rest of the network.

1. Monetary and Development Issues

Monetary compliance issues should be a red flag that the franchisee is in trouble and may be an indication of more systemic problems at the unit level. Start-up franchisors often lack the resources to effectively address monetary defaults and allow these situations to fester. In other cases, they proceed to immediate default and termination. This latter approach is at odds with the emerging franchisor's strategy of increasing overall unit count. The emerging franchisor should have systems and processes in place to monitor financial non-compliance and to escalate these types of defaults for immediate discussion with the franchisee and appropriate attention. The franchisor will want to assess whether additional training or operational support may help address the root cause of the franchisee's non-compliance and, in certain circumstances, it may be appropriate to provide some form of financial relief to the franchisee (*i.e.*, temporary royalty reductions or waivers). If these measures are unsuccessful, the franchisor may wish to approach the defaulting franchisee about a potential exit strategy that would allow the franchisee to transfer its franchised business, thereby preserving the emerging franchisor's growth count as well as avoiding any negative impact on the brand's reputation in the local market that may result from a closed location.

Non-compliance with development obligations may require a tailored approach depending on the reason for the franchisee's failure to meet its contractual development obligations. In some cases, it could be an indication that real estate availability in a particular region is making it difficult for the franchisee to meet its site selection and development obligations. It could also be an indication that the timelines and milestones set out in the franchise agreement are unrealistic, and the emerging franchisor may wish to consider revising its franchise agreement to better align with market realities. Where the franchisee is an area developer or a multi-unit operator and is failing to meet its development schedule obligations, it could be an indication that the franchisor and franchisee need to reassess the feasibility of the franchisee meeting its development obligations and possibly enter into a formal amendment to the existing development schedule that extends the existing deadlines and/or reduces the number of units to be developed or that reduces or eliminates the exclusive territory reserved for development. The emerging franchisor's growth targets may be significantly hampered in situations where it granted large exclusive development territories to its early franchisees and these franchisees are not meeting their development obligations. Although typically a last resort, it may also become clear to the franchisor that it is necessary to issue a formal notice of default with clear steps that must be taken and timelines that must be met by the franchisee, failing which the franchisor may be left with no choice but to exercise its rights under the franchise or development agreement, including reducing the size of the development territory or delivering a notice of termination.

2. Operational Issues – Site Visits

The emerging franchisor will want to develop robust processes and procedures to conduct on-site compliance visits and audits. Regular site visits also help the franchisor identify any franchisees who may be struggling and enable the franchisor and franchisee to work together to address any operational or other performance issues before they become a bigger problem. As the franchisee network grows and as more franchisor representatives are involved in managing the franchisee performance at the unit level, a systemized approach to monitoring and enforcing system standards will help ease the administrative burden of ensuring system compliance. It will also help ensure a greater level of consistency when reviewing and assessing franchisees' compliance with operational requirements and help mitigate the risk of franchisee complaints that they are being singled out or treated differently from other franchisees. In the event of litigation, a well-documented history of a franchisee's operational compliance record is also important where the franchisee's failure to comply ultimately results in the franchisor issuing a notice of default or notice of termination.

3. Warning Letters, Notices of Default, Notices of Termination

It is always a difficult decision to issue a notice of termination in any franchise system, but the emerging franchisor will be particularly burdened by such a decision and will want to ensure that it is well-advised of the legal risks associated with unilaterally terminating the franchise agreement and that it is honoring the parties' respective rights and obligations under the franchise agreement (and any applicable state franchise relationship laws, as discussed below) before issuing the notice of termination. It is imperative that the franchisor maintain a written record of all of the steps it took to support the franchisee and any informal and formal opportunities the franchisee had to correct the operational or other defaults, including through the use of site visit compliance checklists, additional training, warning letters or emails, and one-on-one meetings with the franchisor representative. Prior to issuing a notice of default, the franchisor may wish to send the franchisee a warning letter outlining the various operational and other defaults and summarizing the various measures that the franchisor has taken to provide the franchisee with the support and tools to address the defaults.

The formal notice of defaults must be carefully drafted to ensure compliance with the requirements of the default and termination provisions set out under the franchise agreement (and any applicable state franchise relationship laws as discussed below), and, where applicable, the franchisee must be provided with an opportunity to cure the defaults. The notice of default should include details of the franchisee's non-compliance with its obligations, clearly outline the specific steps the franchisee must take to cure the defaults, and reserve all rights the franchisor may have, including the right to terminate the franchise agreement and enforce the post-termination obligations and restrictive covenants. It is a best practice to remind the franchisee of the post-termination provisions in the franchise agreement, and this can also serve to incentivize the franchisee to bring its operations into compliance with the franchise agreement.

a. State Franchise Relationship Laws

As discussed above, any franchise termination must comply not only with the requirements of the parties' franchise agreement but also any applicable state franchise relationship law. A number of states have franchise relationship laws that limit the grounds upon which the franchisor may terminate, require the franchisor to provide written notice of the default(s) and an opportunity to cure the default(s) prior to termination, and/or require the franchisor to buy back certain assets or collateral upon termination.[80] Accordingly, before issuing any default or termination notice, a franchisor should review the substantive and procedural requirements of both the franchise agreement and any applicable state law (which could be both the governing law designated in the agreement as well as the law of the state in which the franchisee is located).

b. Canadian Duty of Good Faith and Fair Dealing

Like the U.S., Canadian franchisors who exercise a contractual right to terminate the franchise agreement must comply with the terms and conditions of the franchise agreement. In addition, they will be held to the common law and statutory duty of good faith and fair dealing when exercising their contractual discretion and enforcing the franchise agreement.

There is a general organizing principle of good faith in Canadian common law of contract and a more specific duty on parties to perform contractual obligations honestly.[81] This duty requires that parties not lie or otherwise knowingly mislead each other about matters directly linked to the performance of the contract.[82] This organizing principle requires that parties have appropriate regard for the interests of the other contracting party and must perform their duties honestly and reasonably and not capriciously or arbitrarily.[83] However, this principle does not impose on parties a duty of loyalty or of disclosure.[84]

In addition, Canadian provincial franchise legislation imposes upon each party a statutory duty of fair dealing in the performance and enforcement of the franchise agreement, which is essentially a codification of the common law duty of good faith and fair dealing.[85] The legislation in Ontario, PEI, New Brunswick, Manitoba, and British Columbia also specifically includes the duty to act in good faith and in accordance with reasonable commercial standards.[86] The latter three provinces specifically state that the "performance and enforcement" of the franchise agreement includes the exercise of a right under the agreement.[87]

A breach of the duty of good faith and fair dealing provides the franchisee with a statutory

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[80] *See* Section V *infra*; *see also* Appendix B; Elliot Ginsberg & Theresa D. Koller, *Not So Fast My Friend: Key Issues That Arise under Franchise Relationship Laws*, ABA 45TH ANNUAL FORUM ON FRANCHISING W-3 (2022).

[81] Bhasin v. Hrynew, 2014 SCC 71, paras 72-73 (Can.).

[82] *Id.*

[83] *Id.*

[84] *Id.*

[85] Arthur Wishart Act (Franchise Disclosure), 2000, S.O. 2000, c. 3, s. 3(1) – (Ontario); Franchises Act, S.B.C. 2015, c. 35, s. 3(1) – (British Columbia); Franchises Act, S.M. 2010, c. 13, s. 3(1) – (Manitoba); The Franchises Act, S.N.B. 2007, c. F-23.5, s. 3(1) – (New Brunswick); Franchises Act, R.S.A. 2000, c. F-23, s. 7 — (Alberta); Franchises Act, S.P.E.I. 2005, c. 36, s. 3(1) – (Prince Edward Island).

[86] Arthur Wishart Act (Franchise Disclosure), 2000, S.O. 2000, c. 3, s. 3(3) – (Ontario); Franchises Act, S.B.C. 2015, c. 35, s. 3(3) – (British Columbia); Franchises Act, S.M. 2010, c. 13, s. 3(3)(a) – (Manitoba); The Franchises Act, S.N.B. 2007, c. F-23.5, s. 3(3)(a) – (New Brunswick); Franchises Act, S.P.E.I. 2005, c. 36, s. 3(3) – (Prince Edward Island).

[87] Franchises Act, S.B.C. 2015, c. 35, s. 3(1) – (British Columbia); Franchises Act, S.M. 2010, c. 13, s. 3(3)(b) – (Manitoba); The Franchises Act, S.N.B. 2007, c. F-23.5, s. 3(3)(b) – (New Brunswick).

right of damages against the franchisor.[88] Whether a franchisor breaches the duty of good faith will depend on all the circumstances of the case. Not every breach of contract will be a breach of the duty of good faith and it is possible to find an absence of good faith despite strict compliance with the provisions of the franchise agreement. The duty of good faith is limited to an analysis of whether the franchisor has acted in a fair manner according to the specific wording of the agreement. The franchisor does not owe a fiduciary duty to the franchisee, and as such, a franchisor is permitted to act self-interestedly, so long as it deals with the franchisee promptly, honestly, fairly and reasonably, and has regard to the legitimate interests of the franchisee in the outcome of the franchisor's decision and action.[89]

V. ADDRESSING DISSATISFIED FRANCHISEES

A. Implementing and Improving Franchisee Communication Channels

Successful franchising depends on good franchisor-franchisee relationships. Conversely, many preventable complaints and frustrations stem from poor communication between a franchisor and its franchisees. For example, franchisees may not understand the franchisor's expectations in connection with system modifications, new marketing strategies, updated equipment or technology requirements, or limited time offerings. Meanwhile, emerging franchisors may not be aware of franchisees' complaints, concerns, or frustrations regarding the franchisor, the overall system, or certain initiatives and changes. As the franchise system grows, it is no longer always possible or feasible to manage the brand by gathering all operators into the same room or conference call. Maintaining the quality of communication is essential as the number of franchisees expands.

It is important for a franchisor to build various channels of communication in the franchise system. Each franchisor should construct channels to ensure that all franchisees receive important franchisor communications in consistent form at the same time. Harmful distortions can creep in when messages are relayed through third parties or in an unclear, disjointed manner. Using system-wide intranet postings, email blasts, newsletters, Zoom meetings (with a copy archived for those unable to attend), and/or Twitter messages can easily prevent this problem.

Franchisors should also consider holding periodic system-wide conferences or conventions, or a series of regional meetings, to facilitate face-to-face interaction between the franchisor's key staff and franchisees at-large. In the technology age, conferences are less important than they once were for delivering information, but they remain vital for communicating the franchisor's vision for the system's short- and long-term future (including explaining upcoming initiatives, changes, and system modifications), for creating personal communications and relationships, and for kindling (or rekindling) franchisees' enthusiasm for the brand.

Just as it is important for franchisees to hear from the franchisor, it is critical for the franchisor to hear from its franchisees. Simply "feeling heard" can help diffuse frustrations from escalating to costly and relationship-damaging litigation. To this end, the franchisor should consider providing a dedicated "gripe line" or perhaps even a full-time franchisee ombudsman

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[88] Arthur Wishart Act (Franchise Disclosure), 2000, S.O. 2000, c. 3, s. 3(2) – (Ontario); Franchises Act, S.B.C. 2015, c. 35, s. 3(2) – (British Columbia); Franchises Act, S.M. 2010, c. 13, s. 3(2) – (Manitoba); The Franchises Act, S.N.B. 2007, c. F-23.5, s. 3(2) – (New Brunswick); Franchises Act, S.P.E.I. 2005, c. 36, s. 3(3) – (Prince Edward Island).

[89] Fairview Donut Inc. v. The TDL Group Corp., 2012 ONSC 1252, *aff'd*, 2012 ONCA 867, para. 503 (Can.).

outside of the normal hierarchy of field supervision. Though they may be hard to hear, complaints should not be viewed as necessarily destructive. Complaints show that the complainer cares enough to bring the matter to the franchisor's attention. On the other hand, silence can be more dangerous than complaints. While silence could mean that no complaints exists and there is widespread franchisee satisfaction, silence could also mean that franchisee discontent is festering. Each franchisor should facilitate ways for franchisees to constructively voice their complaints and frustrations.

As discussed above, one way franchisees may voice complaints and provide input to the franchisor is through a formal franchisee advisory council ("FAC"). The FAC gives the franchisee community a common outlet to express opinions; to share ideas and input; and to vent criticism about franchisor support, marketing, system modifications, new initiatives and obligations, and countless other aspects of operations and the franchisor-franchisee relationship. At the same time, the FAC gives the franchisor a venue to float trial balloons and adjust strategy with less risk of provoking anxiety in the franchisee community. For example, the franchisor might go to the FAC with a presentation on a possible technology upgrade or brand refresh before staking out a system-wide position – or entering into third-party agreements – that could be difficult to undo. For the FAC to serve its purpose as a constructive communication channel, the FAC must tolerate spirited debate and must fairly represent divergent interests in the franchisee community. The FAC's effectiveness may be undermined if the franchise system as a whole views the FAC as nothing more than cheerleaders for the franchisor.[90]

Finally, if franchisees form an independent franchisee association, it may provide an alternative channel of communication. Absent a contractual obligation, the franchisor is under no legal obligation to "recognize" an independent franchisee association as a bargaining agent for its franchisee members. And there may be little desire to do so on a voluntary basis if, as is often the case, the association forms or becomes active only in a time of system-wide discontent where any communications are likely to be hostile. However, associations sometimes form in less threatening circumstances. Although the franchisor may want assurances that the association has a minimum constituency of existing franchisees, the franchisor should not necessarily rule the association out as a communications channel. Regardless of why an association was originally formed, a franchisor should view the association as a channel for communicating with system. Working with the association can help diffuse franchisee hostility and discontent by showing a willingness to listen and address systemwide concerns.

B. <u>Exiting the System</u>

Neither the franchisor nor the franchisee wants a relationship to fail, but, in some circumstances, a graceful exit from the franchise system is the best option for a franchisee, particularly where the franchisee is disgruntled with the franchisor, system, or brand, or where the franchisee is unable or unwilling to comply with the franchise agreement or brand standards. While these are issues that every franchise system faces, they can be particularly stressful for an emerging franchisor that has not previously dealt with a franchisee who wants out of the system or who should be removed from the system for the good of the brand.

Because most franchise agreements do not permit franchisees to terminate (at least not without a substantial, uncured breach by the franchisor), most franchise terminations are either mutual in nature or effected unilaterally by the franchisor based on one or more defaults by the

[90] *See* Section II.F *supra*, for additional discussion of franchisee advisory councils.

franchisee. Alternatively, a franchisor may allow a disgruntled or non-compliant franchisee to transfer its franchised business to a new operator as part of the franchisee's exit from the franchise system.

1. <u>Mutual Termination</u>

Even where a franchisor has the right and ability to unilaterally terminate a franchise agreement based on the franchisee's uncured default, seeking a mutual termination agreement is often far more attractive and potentially cost-effective option for a franchisor desiring to exit a franchisee from the system. Among other benefits, a mutual termination can provide for a smooth transition, thereby preventing legal disputes and potential evictions (if the franchisor controls the real estate). Further, any franchisee desiring to exit the system or facing termination is likely to be disgruntled and evaluating its potential legal claims against the franchisor. A mutual termination allows the franchisor to mitigate the risk of a franchisee lawsuit by including a release as part of the mutual termination agreement.

In the context of a mutual termination, the parties agree in writing to the terms on which the franchisee will exit the system. The parties will typically sign a termination agreement (which may be called a mutual termination agreement or voluntary termination agreement), outlining the terms on which the outlet will be reacquired or closed, and the settlement of any outstanding amounts owed or other damages. The mutual termination agreement will naturally be specific to the facts and circumstances of each individual termination, but will typically include a number of key provisions, such as:

- <u>Closure or Purchase of Outlet; Wind Down Period</u>. The termination agreement should clarify the date by which the franchisee must cease operation and/or complete an approved transfer. If the franchisee is not required to immediately shut down (or has not already shut down), the termination agreement should expressly require the franchisee to continue operating the outlet under the terms and conditions of the franchise agreement, including paying all royalties and other fees, through the agreed-upon closure date, and should specify the franchisee's deadline for final payment of royalties and other amounts owed through the closure date. If the franchisor elects to reacquire the outlet, the termination agreement may contain the purchase terms and conditions, including purchase price and closing conditions, or may refer to a separate purchase agreement negotiated and executed by the parties. Otherwise, the termination agreement will typically reiterate the broad de-identification and closure obligations under the franchise agreement, as well as calling out any other specific steps the franchisee must take to wind down its operations. Such steps may include returning property of the franchisor, de-identifying the location, cancelling trade names, or transferring administrative controls over any social media accounts.

- <u>Settlement of Monetary Claims</u>. In addition to paying the franchisor any outstanding royalties or other amounts owed through the closure date, some franchisors try to recoup a portion of lost future revenue in exchange for allowing the franchisee out of the relationship prematurely. Some franchise agreements specifically require the franchisee to pay certain liquidated damages upon early termination of the franchise agreement. Even absent such a provision, the franchisor may be able to recover lost future royalties as damages if it initiated litigation against the exiting franchisee for abandoning the franchised business. Therefore, if the franchisee is solvent, the franchisor will often try to recoup some portion (if not all) of its anticipated lost royalties (or the agreed-upon liquidated damages) through a lump sum payment at termination. The termination agreement should detail the amount, terms, and timing of such payment and any other past amounts past. If such agreed-upon payments will be made over time and not in a single lump sum upon termination, the parties may agree to secure future payments via a promissory note or confessed judgment. Alternatively, a franchisor may be willing to forgive some outstanding fees in certain circumstances, particularly where the franchisee is insolvent or otherwise has no ability to pay or where such concession is necessary to secure a mutual termination agreement that includes a release of any claims the franchisee may have against the franchisor.

- Termination of Franchisee's Agreement. The termination agreement will also formally terminate the underlying franchise contracts for that location (including the franchise agreement, guarantees, *etc.*), while reaffirming that certain obligations under the franchise agreement survive termination, either temporarily or indefinitely, such as, for example, indemnification, non-competition, confidentiality, and dispute resolution.

- Release. Most franchisors will demand a general release of all claims from franchisee parties to the termination agreement, releasing all existing claims against the franchisor and its affiliates. As noted above, some states have requirements pertaining to releases that should be carefully observed. There are additional challenges with obtaining an enforceable release of statutory claims under Canadian franchise legislation that will need to be considered and addressed. The outgoing franchisee may demand a parallel release from the franchisor, which, depending on the circumstances, the franchisor may be willing to grant. While covering claims existing as of the termination date, in most cases the release should expressly exclude the parties' surviving obligations under the termination agreement and franchise agreement (such as confidentiality and indemnification).

2. Unilateral Termination

A franchisor's unilateral termination of a franchise agreement can be more complex than a mutual termination, because it is conducted without the input or acquiescence of the franchisee, resulting in a situation that is ripe for disputes. In most cases, franchisors will resort to a unilateral termination only after all other reasonable options have been exhausted, or the defaults rise to the level of serious health, safety, or brand reputation concerns.

As discussed above, some state franchise relationship laws bar a franchisor from terminating a franchisee absent some standard of "good cause." Further, as noted above, several states statutorily require a franchisor to provide the franchisee with written notice of the franchisee's defaults and a specified minimum cure period before the franchisor may proceed with termination (subject to certain narrow grounds that justify immediate termination). In addition, a handful of states also require the franchisor to buy back inventory and supplies of the franchised business at termination. Attached at Appendix B is a summary of state franchise relationship laws regarding termination.

Any termination by the franchisor must comply with the procedural and substantive requirements of the franchise agreement, as well as any applicable state franchise relationship law, including strict compliance with any cause, notice, cure, and buyback requirements. It is best practice for the franchisor's termination notice to identify the specific franchise agreement provisions justifying termination. Further, the termination notice should be drafted with an eye towards evidencing the franchisor's compliance with any applicable state franchise relationship law, even if the particular statute is not directly cited in the notice.

A notice of termination can also contain many of the same demands that might have otherwise been resolved in the mutual termination agreement, such as a demand for payment of amounts past due, lost future revenue, and compliance with all post-termination obligations under the franchise agreement. As with tracking defaults generally, it is important to track the status of each such demand, and follow-up promptly by a formal demand letter or cease-and-desist notice, as appropriate, if the terminated franchisee does not promptly comply with each post-termination obligation. A franchisor should be prepared to initiate litigation or arbitration (per the franchise agreement's dispute resolution provisions) if the franchisee refuses to shut down or otherwise fails to comply with its post-termination obligations.

3. Transfer

Sometimes the negotiated exit of a disgruntled or non-compliant franchisee may involve a transfer of the franchised business to a new operator. Alternatively, a franchisee may desire to sell its franchised business for other reasons, such as retirement. Regardless of the particular motivation, having a proper transfer procedure in place can be critical to a smooth transition. In most circumstances, the first step in a franchise transfer is the franchisee notifying the franchisor that it has found a buyer for its franchised business (although in some circumstances the franchisor may help matching selling franchisees with prospective buyers, particularly in connection with seeking to accelerate the exit of a disgruntled or defaulting franchisee). Once a franchisee has identified a prospective buyer, the process for the franchisor will typically unfold in two principal stages: (i) securing the franchisor's approval (which may involve the franchisor's preliminary review of whether to exercise any contractual right of first refusal, if any), and (ii) preparing the transfer documents.

As a preliminary matter, many franchise agreements grant the franchisor a right of first refusal ("ROFR") to match a third party's bona fide offer for the franchise. Notwithstanding such a contractual right, a new, startup franchisor may not have the capital, operationally resources, or desire to purchase and take over a franchisee's unit. By contrast, a more mature, emerging franchisor may have the financial and operational ability to exercise its ROFR. Presuming a franchisor has the actual ability to exercise a ROFR, whether or not a franchisor should do so turns on various factors, including the franchisor's growth plan (*e.g.*, does the franchisor plan to grow through independent franchises or does the franchisor envision a mix of company-owned and franchised outlets), the importance and value of the particular market at issue, and the franchisor's evaluation of the prospective buyer (*e.g.*, if the franchisor does not like the proposed transfer but does not have strong grounds to reject the transfer under the franchise agreement or applicable law, exercising the ROFR may be the franchisor's best option for legally preventing the transfer to the proposed transferee).

When a prospective buyer is being screened, most franchisors will follow a procedure that is much the same as with screening any other new franchisee. But in addition to the standard methods of evaluating the buyer as a new franchisee, the franchisor must also evaluate the transaction itself, beginning with the purchase agreement. Although the extent of the review of such documentation will depend on the franchisor's resources and risk-aversion, below is a fairly thorough approach to this process. After all, the purchase agreement between buyer and seller controls the terms of the transfer, and the franchisor should review it for certain key provisions:

- Purchase Price. Although the franchisor is neither paying nor receiving the purchase price, franchisors will still be interested in the payment terms because it will impact the buyer's ability to financially support the business after closing. The franchisor will want to compare the amount of the purchase price to the financial resources of the buyer, to ensure that enough funds remain to support ordinary business operations of the franchise after the purchase transaction is completed. In addition, the purchase price provides valuable information for a franchisor as an indicator of the market value of the brand's franchises.

- Conditions to Closing. For the franchisor, the most critical condition to closing is of course the prior approval of the new franchisee and satisfaction of the conditions to transfer set forth in the franchise agreement. The purchase agreement must contemplate obtaining such approval and satisfying such criteria prior to closing. However, the franchisor should ensure it understands all of the other conditions to closing, so that there are no unexpected hurdles or terms that conflict with the franchise agreement.

- Assets. If the buyer is acquiring all of the assets of the franchised business, the franchisor should review the description of the transferred assets carefully to ensure that only property of the seller – and not that of franchisor – is being transferred. For example, under most franchise agreements, the franchisor will retain ownership rights to its intellectual property, goodwill, customer data, and other intangible assets associated with the franchise system. These assets should be excluded from the description of purchased assets to make clear that they belong to the franchisor, and not the selling franchisee.

- Financing. If the buyer has financed any portion of the purchase price, the franchisor may want to review the financing documents, to make sure that the buyer's payment obligations to the bank are subordinate to the buyer's obligations to pay royalties and other amounts owing under the franchise agreement. Additionally, if the buyer has offered any of its assets as collateral for the loan, the franchisor should ensure that such collateral interest does not attach to the goodwill or trademarks associated with the business.

Certain states' laws also regulate the franchisor's ability to approve or disapprove a franchise transfer. See Appendix C.

In connection with the transfer of a franchise, the franchisor will typically prepare a document to memorialize its conditional consent to the transfer, which can have many names, such as "consent to transfer" or "transfer agreement." The transfer agreement will typically be executed by the franchisor, and both buyer and seller, as well as their owners / guarantors. The form of the transfer agreement can vary significantly, but will typically have the following standard provisions:

- Consent / Waiver. The franchisor should grant its consent to the transfer in clear language, subject only to the other express terms of the transfer agreement. Additionally, if the franchise agreement grants the franchisor a right of first refusal, the franchisor may expressly waive its right of first refusal as to the specific transaction authorized by the transfer agreement.

- Conditions to Consent. Because the transfer agreement is often signed in advance of the closing, the approval by franchisor will typically be subject to a number of conditions that must still be met prior to the closing date, including: (i) execution of new franchise documents by the new franchisee; (ii) payment of a transfer fee; (iii) onboarding of the new franchisee, including the timing of any required initial training program; (iv) any obligations to update, refresh, or remodel the outlet and replace equipment to then-current brand standards; (v) approval by the landlord and/or transfer of the lease agreement to the buyer; and (vi) subordination of any financing to the obligations of buyer under the franchise agreement.

- Release. Most franchisors will demand a general release of all claims from selling parties, releasing all prior claims against the franchisor and its affiliates. The underlying franchise agreement often requires the selling franchisee to provide such a release as a condition of franchisor's approval of a requested transfer. Some states have certain requirements regarding releases. For example, California mandates certain specific language be included in the general release for it to be enforceable, while Iowa and Washington prohibit certain releases as a condition to a franchise transfer.[91]

- Termination of Seller. Upon transfer of the franchised business, the franchise agreement of the selling franchisee should be terminated, so that the buyer is the only party with franchise rights to that outlet. That termination is often documented in the same transfer agreement, but will specifically carve-out any outstanding payables and post-term obligations. Some state relationship laws require the franchisor to review the proposed transfer within a certain timeframe, so as to avoid the franchisor dragging its heels. This time frame can range from thirty days to sixty days, and will obviously impact the timing of the franchisor's approval process. These statutes also state that a failure of the franchisor to respond within the specified timeframe will constitute an approval, on the basis of which the franchisee may sell the unit without further notice to the franchisor. Additionally, most of these states require the franchisor to specify in its notice the reasons for any disapproval.

The transfer agreement may also vary depending on the nature of the transfer. For example, if the transfer is not of the entire franchised business, but only of an ownership interest in the franchisee entity, the only condition may be that the new owner signs a personal guaranty of the existing franchise agreement. Alternatively, the transfer agreement may require the selling parties to transfer all of their franchised rights and outlets to the same buyer, meaning the transfer agreement could have to address multiple outlets and agreements.

Franchisors should be aware that some state franchise relationship laws expressly apply to limit the franchisor's ability to freely disapprove a transfer or proposed transferee. A handful of

[91] CAL. CIV. CODE § 1542; IOWA CODE § 523H.5.8 (prohibiting a franchisor from obligating a franchisee to undertake obligations or relinquish any rights unrelated to the franchise proposed to be transferred); WASH. REV. CODE §§ 19.100.180(2)(g), 19.100.220(2) (except in connection with a negotiated settlement of a bona fide dispute, a franchisor cannot require a franchisee to release claims under the Washington Franchise Investment Protection Action); Wash. Dep't Fin. Inst., Franchise Act Interpretative Statement FIS-2: Restrictions on Transfers of Franchises (Nov. 29, 1991), *reprinted in* BUS. FRANCHISE GUIDE (CCH), ¶ 5470.76 (franchisor may require release by the franchisor in connection with transfer so long as it does not include a release of the franchisee's claims under the Washington Franchise Investment Protection; requiring inclusion of such claims in release violates WFIPA).

state laws provide that the franchisor may disapprove a transfer only in a reasonable manner, for example, by responding within a specified time and not charging unreasonable transfer fees. In other cases, the franchisor must have good cause for a transfer denial, such as the proposed transferee fails to meet standard qualifications for a new franchisee or one of the parties is in default to the franchisor. In addition, a handful of states, such as California and Indiana, expressly prohibit a franchisor from denying the surviving spouse, heirs, or estate of a deceased franchisee (or majority owner) the opportunity to participate in the ownership of the franchise for a reasonable period following the franchisee's death or from taking over the business, provided they satisfy franchisee qualifications within a reasonable time.[92] See <u>Appendix C</u> for more information about state franchise relationship laws regulating transfers.

C. <u>Dispute Resolution</u>

Disputes are inevitable in any franchise system. The types of disputes that may arise between franchisors and franchisees are countless. For example, a franchisor may feel compelled to bring legal action against a franchisee to collect unpaid royalties; to enjoin a former franchisee's ongoing use of the franchisor's name, marks, and system following expiration or earlier termination of the franchise agreement; or to force compliance with a covenant not to compete. Alternatively, a disgruntled franchisee may believe the franchisor failed to provide required opening or operational support, misused marketing funds, or made material misrepresentations or omissions during the franchise sales process.

Any dispute could feel like or become a bet-the-company case for a young, emerging franchisor seeking to establish and grow its franchise system, build a positive reputation, and protect its trademarks and intellectual property, often with a small or non-existent legal budget for costly litigation or arbitration. Compounding the threat to an emerging franchisor (and, by extension, the franchise system as a whole) is the fact that some franchisees may have "deeper pockets" to fund litigation than the franchisor itself.

Many franchise agreements require the parties to attempt alternative avenues to resolve their disputes before initiating litigation or arbitration. For example, the franchise agreement may set forth a three-step dispute resolution process: (1) informal negotiation between franchisor and franchisee; (2) non-binding mediation; and (3) if such non-binding dispute resolution efforts failed, binding litigation or arbitration. When there are multiple steps to dispute resolution, it is common for such dispute resolution provisions to contain a carve-out allowing a party to go to court to seek to equitable relief, such a preliminary injunction to enjoin unauthorized use of the franchisor's name and marks post-termination. Engaging in such avenues in good faith can save all parties a lot of money, time, and stress.

1. <u>Typical Considerations Before Filing or Settling Legal Claims</u>

There are numerous factors an emerging franchisor should consider before filing legal action or in evaluating claims asserted against it and the potential settlement of disputes. First, it should go without saying that litigation or arbitration can be very expensive for all parties involved. Even simple, straightforward cases can quickly cost tens or hundreds of thousands of dollars in attorneys' fees, plus the additional expenses or costs for filing fees, expert witnesses, e-discovery platforms, or arbitrator fees. In addition to the potentially high financial cost, a party should consider the cost in personnel time, attention, and distraction that results from litigation. Franchise

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[92] *See, e.g.,* CAL. BUS. & PROF. CODE § 20027; IND. CODE § 23-2-2.7-2(3).

litigation can entail a significant volume of time-consuming written discovery and document collection and production. It can also require a significant time commitment from key executives and personnel of the emerging franchisor, including for document collection, attorney meetings, review of pleadings or briefs, and sitting (and preparing) for depositions and trial / arbitration testimony. As a result, the mere presence of ongoing or threatened litigation can be distraction for key executives whose focus could be elsewhere. This is true of any litigation but can be an especially acute concern for a leanly staffed emerging franchisor.

A franchisor must weigh the potential expense (in money and time) of litigation against the nature of its claims, potential recovery, and interests at stake – as well as the value and threat of any potential claims or counterclaims by the franchisee. When monetary claims are at issue, the critical evaluation is whether the potential monetary recovery justifies the costs of litigating the case. This evaluation should objectively consider the likelihood of prevailing on the merits (that is, the strengths and weaknesses of the franchisor's causes of action as well as the franchisee's likely affirmative defenses and potential counterclaims), the ability to recover attorneys' fees and costs as part of any judgment (either under the parties' contract or in connection with any statutory claims at issue), and likelihood of actually collecting on a judgment.

A franchisor should also carefully consider any non-monetary interests at stake in a dispute. For example, continued use of the franchisor's name and trademark by a former franchisee can dilute the franchisor's trademark and jeopardize the franchisor's rights in the trademark, in addition to seriously confusing and misleading customers to the detriment of the franchisor and the brand as a whole. Improper competition by a former franchisee knowledgeable about the brand's trade secrets, customer lists, strategies, and confidential methods in violation of the post-term covenant not to compete can harm remaining franchisees and imperil the franchisor's ability to refranchise the area. A current franchisee's failure to follow the system and comply with brand standards can damage the brand's reputation and goodwill, thus harming both the franchisor and other franchisees. Quite simply, while a franchisor should not run to court for every nominal breach or violation, a franchisor nevertheless must be prepared to protect the brand.

Indeed, a franchisor's failure to take legal action in certain circumstances may jeopardize its ability to do so in the future. For example, while selective enforcement is rarely a successful defense to traditional breach of contract claim,[93] the unique nature of restrictive covenants – including statutory and common law restrictions on their enforceability, and the facts that they are primarily enforced through equitable actions and restrict future conduct – may make courts more receptive to such arguments in post-term non-compete cases. Faced with a franchisor's lawsuit to enforce a post-termination restrictive covenant, the competing former franchisee may argue that past inconsistent enforcement by the franchisor against other franchisees: (1) undermines the franchisor's claimed justification for the non-compete; (2) shows an injunction is not necessary because the franchisor is not being irreparably harmed by the ongoing competition; or (3) shows the franchisor waived or is equitably estopped from enforcing the restrictive covenant. As discussed below, a franchisor seeking to enforce its post-term covenant not to compete must be

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[93] *See* Original Great Am. Chocolate Chip Cookie Co. v. River Valley Cookies, Ltd. 970 F.2d 273, 279 (7th Cir. 1992) (rejecting terminated franchisee's defense that the franchisor had not terminated other franchisees from underreporting breaches because "liability for breach of contract is strict," and famously observing "[t]he fact that the [franchisor] may, as the [franchisees] argue, have treated other franchisees more leniently is no more a defense to a breach of contract than laxity in enforcing the speed limit is a defense to a speeding ticket.").

prepared to explain any prior selective enforcement of the restrictive covenant.[94] Inconsistent enforcement of a non-compete may jeopardize a franchisor's ability to establish that the non-compete is reasonable and necessary, and thus valid and enforceable.[95] A former franchisee could argue that a franchisor's inconsistent enforcement against other former franchisees shows that the franchisor either does not have a protectable interest to justify the non-compete or that the non-compete is broader than necessary to protect such interest.[96] For example, several courts have held that protection of a franchisor's trade secrets and confidential information is a legitimate interest that can support enforcement of a post-termination covenant not to compete.[97] However, the argument for protecting a franchisor's purported trade secrets appears much less compelling where a franchisor knowingly allows other former franchisees who possessed the franchisor's trade secrets to compete against the franchisor without action. Indeed, failure to maintain its secrecy jeopardizes trade secret status.[98] In addition, as noted above, a franchisor may jeopardize ongoing legal recognition of its trademarks if it knowingly allows unauthorized use of the trademarks by former franchisees or others.

Further, there is some risk that failing to act to enjoin certain types of misconduct by some current or former franchisees could jeopardize a franchisor's ability to enjoin similar misconduct in the future. For example, allowing other former franchisees to compete in violation of a post-term non-compete covenant may undercut a franchisor's argument that it will suffer prospective or ongoing "irreparable harm," which is a required showing for any injunction.[99] On the other hand, other courts have concluded that past selective enforcement will not preclude a finding of irreparable harm as long as the franchisor can offer a rational business explanation for why it sought to enforce its post-term non-compete against some former franchisees but not others.[100]

Additionally, as it should be for any prospective litigant, an objective evaluation of the

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[94] *See* Jess A. Dance & William W. Sentell, *Turning an (Occasional) Blind Eye: Selective Enforcement of Franchisee Post-Term Non-Compete Covenants*, 37 FRANCHISE L.J. 245, 253-63 (2017).

[95] *Id*. at 257-60.

[96] *Id.* at 257.

[97] *See, e.g.,* Sylvan Learning, Inc. v. Gulf Coast Educ., Inc., No. 1:10-CV-450-WKW [WO], 2010 WL 3943643, at *6 (M.D. Ala. Oct. 6, 2010) (enforcing a covenant not to compete where the franchisee had "continued to use [the franchisor's] goodwill, method of operation, and client list to operate his own independent learning center after the termination").

[98] Cf. Motor City Bagels, L.L.C. v. Am. Bagel Co., 50 F. Supp. 2d 460, 480 (D. Md. 1999) (finding no trade secret protections where the "plaintiffs simply did not act reasonably in seeking to ensure the secrecy of their plan"); McAlpine v. AAMCO Automatic Transmissions, Inc., 461 F. Supp. 1232, 1256 (E.D. Mich. 1978) ("The subject of a trade secret must be secret, and must not be part of the public knowledge or of general knowledge in the trade or business involved.").

[99] *See, e.g.*, Baskin-Robbins Inc. v. Patel, 264 F. Supp. 2d 607, 612 (N.D. Ill. 2003) (declining to issue a preliminary injunction due to the franchisor's selective enforcement of its non-compete). In that case, after Baskin-Robbins made the business decision to move away from "standalone" ice cream shops in favor of stores offering ice cream, doughnuts, and sandwiches, many former Baskin-Robbins stores converted to a competing brand, KaleidoScoops. *Id*. at 609. Although Baskin-Robbins objected to some of the conversions and sought to enforce its non-compete, in many instances it chose not to enforce the covenants. *Id.* In light of evidence that Baskin-Robbins had allowed other former franchisees to convert to a competing brand, the court denied the requested injunction for failure to establish irreparable harm. *Id*. at 610-11.

[100] Jess Dance, Robert Einhorn & Heather Carson Perkins, *Enforcing System Standards—A Franchisor's Prerogative?*, ABA 41ST ANNUAL FORUM ON FRANCHISING W-10, at 14 (2018).

strengths and weaknesses of a claim, including the availability of evidence, is paramount in deciding whether to bring a legal action or settle a threatened claim. This is especially so for an emerging franchisor because any case can be precedent-setting case for the system. For example, just as a court order finding the franchise agreement's non-competition covenant to be valid and enforceable can dissuade other franchisees from seeking to violate the non-compete in the future (and provided favorable legal precedent for future cases), a court loss in a franchisor's first effort to enforce its non-compete could embolden other franchisees breach the covenant. As a result, an emerging franchisor may desire to wait for the "right" case before filing a lawsuit that will test its non-compete for the first time. In short, a franchisor should carefully consider the implications of filing – or not filing – legal action.

2. Item 3 Disclosure Requirements

In addition to the general considerations noted above, an emerging franchisor (indeed, any franchisor) should specifically think about its disclosure obligations in evaluating whether to file or preemptive settle legal action. Broadly speaking, Item 3 requires franchisors to disclose information regarding three types of disputes: (1) pending administrative, criminal, and material civil actions that involve any administrative, criminal, or material civil action that alleges a violation of a franchise, antitrust, or securities law, or that alleges fraud, unfair or deceptive trade practices, or comparable allegations, or other civil actions that are material to the franchise system or its business operations; (2) material civil actions involving the franchise relationship filed in the previous fiscal year (specifically including franchisor-initiated actions against current or former franchisees); and (3) prior actions concluded within the preceding ten years in which the franchisor-related party was convicted of or plead *nolo contendre* to a felony charge or was held liable for violations of a franchise, antitrust, or securities law, or fraud, unfair or deceptive trade practices, or comparable allegations, including any civil action.[101] For this disclosure, "held liable" means that a party was required to pay money or other consideration, was required to reduce an indebtedness by the amount of an award, was not allowed to enforce its rights, or was required to take action adverse to its interests.[102]

While Item 3 requires disclosure of various types of pending and concluded franchise litigation, disputes settled before litigation or arbitration is filed (including disputes settled through mediation) are not required to be disclosed in Item 3.[103] As a result, experienced franchisee counsel use the threat of Item 3's disclosure requirements to leverage a pre-suit settlement from the franchisor. This is something an emerging franchisor – indeed, any franchisor – should consideration in deciding whether or settle or otherwise avoid litigation.

Separate from any Item 3 obligations, a franchisor should also consider what message litigation, settlement, or inaction sends to existing and prospective franchisees. Some franchisor-initiated litigation can signal to the franchise network that the franchisor will aggressively protect the brand for the good of all franchisees, for example by ensuring that existing franchisees are complying with brand standards or by protecting current franchisees from improper competition by former franchisees. Conversely, failing to act against a non-compliant franchisee could send the message that franchisor will not hold current or former franchisees to their financial and operational obligations, thus encouraging more "bad apples" in the future. On the other hand,

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[101] 16 C.F.R. § 436.5(c); FTC COMPLIANCE GUIDE, *supra* note 20, at 35-37.

[102] 16 C.F.R. § 436.5(c)(1)(iii)(B); FTC COMPLIANCE GUIDE, *supra* note 20, at 37.

[103] FTC COMPLIANCE GUIDE, *supra* note 20, at 34–35.

aggressive franchisor legal action over perceived "minor" issues may appear to other franchisees to be petty, vindictive, or heavy handed, and thus could risk straining the franchisor's relationship with its existing franchise network.

3. Insurance

Before launching its franchise system (and thus hopefully long before facing the threat of franchisee lawsuits), an emerging franchisor should carefully consider (and reconsider, as the system grows and evolves) its insurance needs, including appropriate coverages in light of potential exclusions and deductibles. In obtaining insurance, a franchisor should consider, among other things, the types of legal claims it may face from its franchisees or its franchisees' employees or customers. For example, while no insurance policy will ultimately protect a franchisor that intentionally breached a contract or committed fraud, a standard professional liability insurance policy, also called errors and omissions insurance (E&O) policy, may apply to many types of legal claims a franchisee may assert against its franchisor. Years (hopefully) later, an emerging franchisor facing its first lawsuit by a disgruntled franchisee may be pleasantly surprised to realize they have insurance coverage as to some or all of the franchisee's claims.

Upon receipt of a franchisee's demand letter, arbitration demand, or complaint, the franchisor should review its insurance coverage and tender the claim to its provider as appropriate. Many insurers will offer to provide panel counsel to defend the franchisor from the franchisee's claims. Because franchisor-franchisee disputes can have various unique aspects that distinguish them from common contract or tort actions, a franchisor should work with the insurer to obtain pre-approval to be represented by experienced franchise counsel. In the authors' experience, insurers will often consent to non-panel franchise litigation counsel, though the insurer may only agree to cover a portion of non-panel counsel's rates – leaving the remainder to the franchisor. While the prospect of having insurance fully fund a legal defense with panel counsel is certainly attractive to any franchisor (particularly an emerging franchisor will little to no budget to fund litigation), it can be shortsighted and ultimately much more time consuming and expensive for a franchisor facing suit to elect for cheaper panel counsel instead of an experienced franchise litigator (or, a minimum, a lawyer familiar with the franchisor's system). However, if insurance will not agree to non-panel counsel (even at reduced rates), an alternative is for the franchisor to have its franchise counsel serve as in-house counsel in supervising panel counsel. This approach can reap the cost savings of having insurance pay for panel counsel, while ensuring the franchisor has someone with franchise experience guiding panel counsel.

VI. MAINTAINING RECORDS

A. Franchisee Files

As the franchise system grows, it is critical that the franchisor maintain complete franchisee files containing executed agreements, business records, correspondence, and ancillary documents for each franchisee. Among other things, franchisors should obtain and maintain copies of the following for each franchisee: (1) the submitted franchise application (and any supporting materials); (2) a signed FDD receipt;[104] (3) if the franchisor relies on a registration and/or disclosure exemption in connection with the franchise sale, documentation supporting reliance on the exemption, including any acknowledgment signed by the franchisee; (4) complete,

[104] For each completed sale, the FTC Franchise Rule requires the franchisor to retain a copy of the signed FDD receipt for at least three years. 16 C.F.R. § 436.6(i).

executed copies of all area development agreements and franchise agreements (including executed copies of any guarantees, software licenses, franchise sales questionnaire, or other ancillary agreements attached thereto); (5) copies of contractual amendments, addenda, or extensions; (6) executed EFT/ACH authorizations; (7) site selection reports and consents; (8) executed copies of the franchisee's lease and any lease rider required by the franchisor; (9) copies of the franchisee's insurance policies or other periodically updated evidence that the franchisee is maintaining all required insurance and endorsements, including naming the franchisor as an additional insured if required by the franchise agreement (and emerging franchisors, like all franchisors, should require this in most instances); (10) copies of all inspection reports and other correspondence relating to operational issues; (11) copies of any formal notices under the franchise agreement, including notices of default, non-renewal, or termination; (12) copies of correspondence with the franchisee, including complaints or demand letters; (13) settlement agreements; (14) documentation regarding any transfer requests; and (15) any other documents, consents, waivers, releases, agreements, or notices pertaining to the franchise.

B. Miscellaneous

1. Naming Conventions

When a franchise system is brand new with only a handful of franchisees, it is easy enough for a franchisor to know (or quickly determine) which agreements, reports, or other documents involve which franchisees. However, as the system grows, it becomes increasingly important, logistically and operationally, for the franchisor to develop and maintain uniform conventions for identifying and referring to franchised outlets and for saving agreements, records, correspondence, and related documents in the master franchisee files. For example, a franchisor may elect to identify each U.S. location by an alpha-numeric code incorporating the franchisee's state and location number. Under this example, the first franchise in California may be referred to as CA01, while the second California franchise may be called CA02, and so on. In addition to the alpha-numeric code, the franchisor may assign each outlet an internal name associated with the outlet's location, such as Sacramento North or Sacramento South. On a related note, for consistency and clarity in correspondence and internal records, it is important to correctly identify each franchisee by its legal entity name, rather than the name of one of the principal owners or nickname, to ensure that all agreements, correspondence, and other documents are prepared correctly and quickly using the correct legal entity for each outlet.

2. Execution Formalities

Notwithstanding the best prepared agreement forms, it is not uncommon for a franchisor to discover upon after-the-fact review that its franchise agreements are (1) missing key signatures; (2) signed on behalf of entities that were never actually formed; (3) signed with signatures that do not match the names of the parties or guarantors; and/or (4) without executed personal guarantees. In the rush to get the deal done and collect the initial franchise fees, the franchisor may miss such execution errors or oversights, which can have significant consequences in the event of future disputes regarding how (and against whom) the franchise agreement, its guarantees, and other ancillary agreements can be enforced.

Each franchisor, including emerging franchisors, should institute strict execution formalities. In addition to confirming that each franchisee that is a business entity is properly formed, in good standing, and authorized to enter into such an agreement, the franchisor should take steps to ensure – before countersigning the franchise agreement – that: (1) all agreements have legible signatures; (2) all names match their respective signature; (3) if multiple signatures are on one page, that all such signatures have been secured; (4) documents with a date line have been dated; (5) all blanks (such as the franchisee's notice address and contact information) have been filled in; and (6) guarantees are fully executed by all guarantors (and their spouses, where required).

To help minimize execution errors and omissions, the franchisor can consider using an electronic signature process or technology, such as DocuSign, to help automate the process, and, through pre-programming, prevent missed signatures, dates, and other errors.

Another common oversight is that certain key exhibits intended to be completed post-execution are never updated or filled in. For example, a common exhibit that often goes incomplete is the exhibit that identifies the specific approved site location, protected territory, and/or opening date, which generally cannot be fully and finally completed until the franchisee has located a specific site that the franchisor has approved and/or the unit has opened. It is important for each franchisor to implement processes to ensure that part of the site approval process includes completing (and re-executing if required by the franchise agreement) the key exhibits identifying the approved site.

3. <u>FDD Version Control</u>

Having spent significant time and resources to prepare its initial FDD and forms of agreement, an emerging franchisor may not initially appreciate how much its FDD and form agreements may evolve over time, even in a single year. It is common for a franchisor's issued FDD to go through more than one version in a year, either as a result of making changes requested by various registration states' comment letters or due to post-effective amendments to the offering or forms of agreement. Regardless of the reason for such mid-year changes, it is important for a franchisor to maintain proper version control in labeling the various versions of a franchisor's FDD (including the forms of agreement attached to the FDD) for multiple reasons. First, tracking which states registered which specific version of the franchisor's FDD makes it easier to ensure the franchisor runs the correct redline (or blackline) for each state in connection with registration renewals or amendments. Similarly, it is critical for an emerging franchisor, like any franchisor, to proper track FDD issuance dates, registration effective dates, and expiration dates to ensure sales are not made during "dark" periods.

Second, it is common for the franchisor's form of franchise agreement (or ADA or other agreements) to evolve over time. As the franchise system grows (and the agreements evolve), having a footer in the executed franchise agreement that includes the document's version number makes it much easier for the franchisor to quickly identify and track which specific franchisees are under which particular versions of the franchise agreement.

VII. CONCLUSION

After launching its franchise system, new and emerging franchisors will undergo a variety of challenges and growing pains. However, these growing pains are not uncommon and can often be managed or predicted with proper counsel and strict adherence to the franchise disclosure laws.

APPENDIX A

FRANCHISE QUESTIONNAIRE

The purpose of this **FRANCHISE QUESTIONNAIRE** is to determine whether any statements or promises were made to you that we have not authorized and that may be untrue, inaccurate, or misleading. Please review each of the following questions and statements carefully and provide honest and complete responses to each.

1. Have you received and personally reviewed our Franchise Agreement and any attachments to it?

   Yes: ☐ **No**: ☐

2. Have you received and personally reviewed our Franchise Disclosure Document ("FDD")?

   Yes: ☐ **No**: ☐

3. Did you sign a Receipt for the FDD indicating the date you received it?

   Yes: ☐ **No**: ☐

4. Have you discussed the benefits and risks of purchasing a _____ franchise with an attorney, accountant, or other professional advisor?

   Yes: ☐ **No**: ☐

   If "No," do you wish to have more time to do so?

   Yes: ☐ **No**: ☐

5. Do you understand that the success or failure of your _____ franchise will depend in large part upon your skills and abilities, competition from others, and other economic and business factors?

   Yes: ☐ **No**: ☐

6. Has any employee or other person speaking on our behalf made any statement or promise concerning the revenues, profits, or operating costs of a _____ franchise?

   Yes: ☐ **No**: ☐

7. Has any employee or other person speaking on our behalf made any statement (other than the information contained in Item 19 of the FDD), or any promise regarding the amount of money you may earn in operating a _____ franchise?

   Yes: ☐ **No**: ☐

8. Has any employee or other person speaking on our behalf made any statement or promise concerning the likelihood of success that you should or might expect to achieve from operating a _____ franchise?

Yes: ☐ **No**: ☐

9. Has any employee or other person speaking on our behalf made any statement, promise, or agreement concerning the training or support service or other assistance that we will furnish to you that is contrary to, or different from, the information contained in the FDD?

Yes: ☐ **No**: ☐

10. Have you paid any money to us concerning the purchase of your _____ franchise prior to today?

Yes: ☐ **No**: ☐

11. If you answered "Yes" to any of Questions 6 to 10, please provide a full explanation of each "Yes" answer in the following blank lines. Attach additional pages, if necessary, and refer to them below.

____

____

____

____

____

____

____

____

____

12. I signed the Franchise Agreement and Addendum (if any) on _______________, 20___, and acknowledge that no Franchise Agreement or Addendum is effective until signed and dated by _____.

Your responses to these questions are important to us and we will rely on them.

By signing below, you are representing that you have responded truthfully to the above questions.

FRANCHISEE APPLICANT:

By: ______________________________
Name: ______________________________

Date: ____________

APPENDIX B

SUMMARY OF STATE FRANCHISE RELATIONSHIP LAWS REGARDING TERMINATION		
State	**Statute**	**Description**
Arkansas	Arkansas Franchise Practices Act, ARK. CODE ANN. §§ 4-72-202 – 204	Franchisor may not terminate a franchise agreement without: (a) good cause; (b) 90 days' written notice; and (c) a 30-day cure period (10-day cure period for repeated deficiencies occurring within a 12-month period), though some enumerated defaults are subject to immediate termination. The Arkansas Franchise Practices Act does not apply to franchises subject to the FTC Franchise Rule.
California	California Franchise Relations Act, CAL. BUS. & PROF. CODE §§ 20020-22, 20030	Franchisor may not terminate a franchise agreement without "good cause," defined as failure of the franchisee to substantially comply with any lawful requirement of the franchise agreement after applicable cure period. For franchise agreements entered into or renewed on or after January 1, 2016, terminations for "good cause" require 60 days advance notice, and a cure period between 60 and 75 days from the date of notice. For any other franchise agreement, terminations made for "good cause" may be effected after giving notice and a reasonable opportunity to cure, which need not exceed 30 days. A franchisor may immediately terminate the franchise agreement with notice upon: bankruptcy or insolvency of the franchised business; voluntary abandonment; franchisee's failure to comply with applicable law (after 10 days' notice); franchisee's repeated failure to comply with the terms of the franchise agreement; seizure of the franchised business's assets; parties' mutual written agreement to terminate; franchisee's conviction for a felony or conduct that reflects materially and unfavorably upon the operation and reputation of the franchise business or system; imminent danger to public health or safety; franchisee's material misrepresentations in connection with the acquisition of the franchise. Notices of termination must be: (i) in writing; (ii) posted by registered, certified or other receipted mail; (iii) delivered by telegram or personally delivered to the franchisee; (iii) contain a statement of intent to terminate and the reasons therefore; and (iv) specify the effective date of termination. Upon a lawful termination or nonrenewal, the franchisor must purchase from the franchisee, at the value of price paid, minus depreciation, all inventory, supplies, equipment, fixtures, and furnishings purchased or paid for under the terms of the franchise agreement or any ancillary or collateral agreement by the franchisee to the franchisor or its approved suppliers and sources, that are, at the time of the notice of termination or nonrenewal, in the possession of the franchisee or used by the franchisee in the franchise business. There are multiple exceptions to the buyback requirement including if the franchisor does not prevent the franchisee from retaining control of

SUMMARY OF STATE FRANCHISE RELATIONSHIP LAWS REGARDING TERMINATION		
State	**Statute**	**Description**
		the principal place of the franchise business or if the parties mutually agree to terminate or not renew the franchise.
Connecticut	Connecticut Trading Stamps, Mail Order, Franchises, Credit Programs, Subscription Act, CONN. GEN. STAT. § 42-133f	Franchisor may not terminate the franchise agreement without good cause, including, without limitation, franchisee's refusal or failure to comply substantially with any material and reasonable obligation of the franchise agreement. Termination requires 60 days' notice, except franchisor may terminate upon 30 days' written notice if franchisee abandons the franchise relationship and franchisor may immediately terminate upon notice if franchisee is convicted of felony directly related to the franchised business. If franchise is on premises leased by the franchisor to franchisee, notice must be served by neutral party and state the lease will terminate and the franchisee may have certain rights under the Connecticut law. Upon termination franchisor must fairly and reasonably compensate the franchisee for inventory, supplies, equipment, and furnishings.
Delaware	Delaware Franchise Security Law, DEL. CODE § 6-25-2551 – 2556	Franchisor may not unjustly terminate a franchise (unjust is defined as without good cause or in bad faith) and must provide at least 90 days' notice of termination.
Hawaii	Hawaii Franchise Investment Law, HAW. REV. STAT. § 482E-6	Franchisor may not terminate the franchise agreement except for good cause, or in accordance with the current terms and standards established by the franchisor then equally applicable to all franchisees, unless and to the extent that the franchisor satisfies the burden of proving that any classification of or discrimination between franchisees is reasonable, is based on proper and justifiable distinctions and is not arbitrary. Good cause includes, but is not limited to, franchisee's failure to comply with any lawful, material provision of the franchise agreement after having been given written notice thereof and an opportunity to cure the failure within a reasonable period of time. Upon termination the franchisor must compensate the franchisee at fair market value for inventory, supplies, equipment, and furnishings.

SUMMARY OF STATE FRANCHISE RELATIONSHIP LAWS REGARDING TERMINATION		
State	**Statute**	**Description**
Illinois	Illinois Franchise Disclosure Act of 1987, 815 ILL. COMP. STAT. 705/19	Franchisor may not terminate a franchise agreement without good cause, which includes but is not limited to, franchisee's failure to comply with any lawful provision of the franchise or other agreement after 30 days' notice and opportunity to cure. Franchisor may immediately termination, without prior or opportunity to cure, if franchisee: makes an assignment for the benefit of creditors or a similar disposition of the assets of the franchised business; voluntarily abandons the franchise business; is convicted of a felony or other crime which substantially impairs the good will associated with the franchisor's trademark, service mark, trade name or commercial symbol; or repeatedly fails to comply with the lawful provisions of the franchise or other agreement.
Indiana	Indiana Deceptive Franchise Practices Act, IND. CODE ANN. § 23-2-2.7-1(7), -3	Franchisor may not include a provision in the franchise agreement permitting it to unilaterally terminate if such termination is without good cause (defined as failure to comply with any material provision of the franchise agreement). Unless otherwise provided for in the franchise agreement, franchisor may not terminate the franchise agreement without providing at least 90 days' notice of termination.
Iowa	Iowa Franchise Act, IOWA CODE § 537A.10(7) (for franchise agreements entered into on or after July 1, 2000)	Franchisor may not terminate a franchise agreement without good cause. "Good cause" is "cause based upon a legitimate business reason" and includes noncompliance with any material lawful requirement of the franchise agreement. Termination may not be arbitration or capricious. Termination requires written notice stating basis for termination, with a "reasonable cure period" of at least 30 to 90 days (with a 30-day cure period for payment defaults). Franchisor may immediately terminate upon notice, without providing an opportunity to cure, upon: bankruptcy or insolvency, or assignment of assets to creditor; voluntary abandonment; mutual written agreement to terminate; seizure or foreclosure of the franchised business; franchisee knowingly makes material misrepresentations in connection with the acquisition, ownership, or operation of the franchise; felony conviction related to the franchise; conduct that materially and adversely affects the operation, maintenance, or goodwill of the franchise;

SUMMARY OF STATE FRANCHISE RELATIONSHIP LAWS REGARDING TERMINATION		
State	**Statute**	**Description**
		imminent danger to public health or safety; repeated failure to comply with material provisions of the franchise agreement.
Michigan	Michigan Franchise Investment Law, MICH. COMP. LAWS § 445.1527	Franchisor may not terminate the franchise agreement without good cause, including franchisee's failure to comply with any material and reasonable obligation of the franchise agreement, after being given written notice and a reasonable cure period of up to 30 days.
Minnesota	Minnesota Franchises Act, MINN. STAT. § 80C.14	Franchisor may not terminate the franchise agreement without: (i) good cause (defined as failure of franchisee to substantially comply with material and reasonable franchise requirements imposed by the franchisor); (ii) 90 days' written notice; and (iii) a 60-day cure period. Termination may be effective immediately with notice upon: voluntary abandonment of the franchise relationship by the franchisee; franchisee's conviction for an offense directly related to the business conducted pursuant to the franchise; or franchisee's failure to cure a default under the franchise agreement that materially impairs the good will associated with the franchisor's trade name, trademark, service mark, logotype or other commercial symbol after the franchisee has received written notice and a 24-hour opportunity to cure. Statutorily enumerated examples of good cause include: (i) bankruptcy or insolvency of the franchisee; (ii) assignment for the benefit of creditors or similar disposition of the assets of the franchised business; (ii) voluntary abandonment of the franchised business; (iii) conviction or a plea of guilty or no contest to a charge of violating any law relating to the franchise business; and (iv) any act by or conduct of the franchisee which materially impairs the goodwill associated with the franchisor's trademark, trade name, service mark, logotype or other commercial symbol.
Mississippi	Mississippi Franchises Act, MISS. CODE § 75-24-53	Franchisor may not terminate a franchise agreement without 90 days' written notice of termination, provided that 90 days' notice is not required in the event of criminal misconduct, fraud, abandonment, bankruptcy or insolvency of the franchisee, or the giving of a no account or insufficient funds check.

SUMMARY OF STATE FRANCHISE RELATIONSHIP LAWS REGARDING TERMINATION		
State	**Statute**	**Description**
Missouri	Missouri Pyramid Sales Scheme Act, MO. REV. STAT. § 407.405	Franchisor may not terminate a franchise agreement without 90 days' written notice of termination, unless termination is for: criminal misconduct, fraud, abandonment, bankruptcy or insolvency of the franchisee, or the giving of a no account or insufficient funds check.
Nebraska	Nebraska Franchise Practices Act, NEB. REV. STAT. § 87-404	Franchisor may not terminate a franchise agreement without good cause (defined as franchisee's failure to substantially comply with the requirements imposed upon him or her by the franchise). Termination requires 60 days' written notice, but only 15 days' written notice is required if termination is based on voluntary abandonment. Franchisor may terminate the franchise agreement immediately with notice upon: franchisee's conviction for an indictable offense directly relating to the business conducted pursuant to the franchise; franchisee's insolvency or the institution of bankruptcy or receivership proceedings; franchisee's default in payment of an obligation or failure to account for the proceeds of a sale of goods by the franchisee to the franchisor or a subsidiary of the franchisor; franchisee's falsification of records and reports required by the franchisor; the existence of an imminent danger to public health or safety; or loss of the right to occupy the premises from which the franchise is operated.
New Jersey	New Jersey Franchise Practices Act, N.J. STAT. § 56:10-5	Franchisor may not terminate a franchise agreement without good cause, which is limited to failure by the franchisee to substantially comply with the requirements imposed upon franchisee by the franchise. Termination requires 60 days' written notice, or only 15 days' written notice of termination is based on abandonment. Termination is effective immediately upon written notice of a felony conviction related to the franchise.
Rhode Island	Rhode Island Fair Dealership Act, R.I. GEN. LAWS §§ 6-50-2, 6-50-4, 6-50-5	Termination requires good cause, including: (i) failure to comply with reasonable requirements; (ii) voluntary abandonment; (iii) felony conviction related to the franchise; (iv) substantial action impairing goodwill, trade name, trademark, service mark, or commercial symbols; (v) material misrepresentation relating to franchise; (vi) unauthorized transfer; (vii) insolvency or bankruptcy; and (viii) assignment for the benefit of creditors. Termination requires 60 days' written notice stating basis for termination, or with a 30-day cure period, is required for terminations for failure to comply with reasonable requirements, provided franchisee has had the right to cure 3 times in any annual period. Termination is effective immediately upon written notice for (ii) – (viii) in definition of "good cause". Termination based on nonpayment requires a 10-day cure period

SUMMARY OF STATE FRANCHISE RELATIONSHIP LAWS REGARDING TERMINATION		
State	**Statute**	**Description**
		after written notice, provided franchisee has had the right to cure 3 times in any annual period. Termination based on violations of public health or safety requires a 24-hour cure period after written notice. At the franchisee's option, the franchisor must repurchase all inventory at the fair, wholesale market value.
Virginia	Virginia Retail Franchising Act, VA. CODE ANN. § 13.1-564	Franchisor may not terminate a franchise without reasonable cause or use undue influence to induce a franchisee to surrender any right given to franchisee by any provision contained in the franchise agreement.
Washington	Washington Franchise Investment Protection Act, WASH. REV. CODE § 19.100.180(j)	Franchisor may not terminate a franchise agreement without good cause, including, without limitation, franchisee's: (i) failure to comply with lawful material provisions of the franchise or other agreement between the parties; and (ii) franchisee's failure cure such default after 30 days' notice and opportunity to cure, or if such default cannot reasonably be cured within 30 days, the failure of the franchisee to initiate a cure within 30 days. Franchisor may immediately terminate upon notice if franchisee: commits of four willful and material breaches of same term of the franchise agreement in any 12-month period (after notice and opportunity to cure on the first three breaches); is adjudicated bankrupt or insolvent, or makes an assignment for the benefit of creditors or similar disposition of the assets of the franchised business; voluntarily abandons the franchised business; or is convicted of or pleads guilty or no contest to a charge of violating any law relating to the franchised business. Franchisor must purchase inventory and supplies at fair market value at the time of termination, excluding personalized materials, inventory or supplies not required for the franchise, and inventory and supplies not purchased from the franchisor or by express requirement if the franchisee retains the premises. Amounts paid for inventory and supplies may be offset against outstanding amounts owed.

SUMMARY OF STATE FRANCHISE RELATIONSHIP LAWS REGARDING TERMINATION		
State	**Statute**	**Description**
Wisconsin	Wisconsin Fair Dealership Law, WIS. STAT. §§ 135.02 – 135.045	Termination requires good cause, which means the failure to comply substantially with essential, reasonable, and non- discriminatory requirements, or act in bad faith in carrying out the terms of the franchise. Termination generally requires 90 days' written notice stating the basis for termination and a 60-day cure period. Termination for nonpayment of amounts due requires 90 days' written notice and a 10-day cure period. Termination is effective immediately for bankruptcy, insolvency, or an assignment for the benefit of creditors. At the option of franchisee, the franchisor must repurchase all inventory at the fair, wholesale market value.

SUMMARY OF STATE FRANCHISE RELATIONSHIP LAWS REGARDING TRANSFERS		
State	**Statute**	**Description**
Arkansas	ARK. CODE ANN. § 4-72-205(b)(1)-(2)	Within 60 days after receipt of notice of franchisee's transfer request, franchisor must either approve or disapprove in writing requested transfer. If franchisor refuses to approval requested transfer, franchisor must provide written notice advising franchisee of material reasons for denial relating to the character, financial ability, or business experience of the proposed transferee. Approval is deemed granted if franchisor does not respond within 60 days.
California	CAL. BUS. & PROF. CODE. § 20027	After death of franchisee or majority owner, the surviving spouse, heirs, or estate have a right to participate in the franchised business for a reasonable time, but survivor must satisfy all qualifications to act as franchisee within that time period. A franchisor cannot prevent the surviving spouse, heirs or estate from participating in franchise ownership for a reasonable time after death. During that time, the survivor must satisfy all of the franchisor's qualifications itself, or sell to a transferee who does. The rights are subject to the survivor maintaining all standards and obligations of the franchise. Statute specifically authorizes franchisor to exercise rights of first refusal.
Hawaii	HAW. REV. STAT. § 482E-6(2)(I)(i)-(iv)	Franchisor has 30 days after notice from franchisee to respond to transfer request, or request is deemed approved. Any denial must include franchisor's reasons for disapproval. Franchisor may not disapprove of transfer request without good cause, which includes (i) proposed buyer failing to meet reasonable qualifications or standards, (ii) transferee is a competitor, (iii) transferee refuses to agree to comply with lawful obligations imposed by franchisor, including signing a new form of franchise agreement, or (iv) franchisee or transferee fail to pay franchisor any sums owed or cure any defaults under any agreement.
Indiana	IND. CODE § 23-2-2.7-2(3)	After death of franchisee or majority owner, the surviving spouse, heirs, or estate have a right to participate in the franchised business for a reasonable time, but survivor must satisfy all qualifications to act as franchisee within that time period.
Iowa	IOWA CODE § 537A.10(5) (for franchise agreements entered into on or	Franchisor has 60 days after notice from franchisee to respond to transfer request, or request is deemed approved. Franchisor may not disapprove of transfer request if transferee satisfies reasonable current qualifications for new franchisees. Reasonable current qualifications include qualifications based on legitimate business reasons, which are not arbitrary or capricious. Franchisor must permit the transfer of seller's unexpired term of the franchise and cannot require the transferee to sign a new or different franchise agreement as condition

SUMMARY OF STATE FRANCHISE RELATIONSHIP LAWS REGARDING TRANSFERS		
State	**Statute**	**Description**
	after July 1, 2000)	of transfer if there is an unexpired franchise. No discrimination on basis of race, color, national origin, religion, sex, or disability.
Michigan	MICH. COMP. LAWS § 445.1527(g)	No disapproval without good cause, which includes (i) proposed buyer failing to meet reasonable qualifications or standards, (ii) transferee is a competitor, (iii) transferee refuses to agree to comply with lawful obligations, or (iv) franchisee or transferee fail to pay franchisor any sums owed, or cure any defaults under franchise agreement.
Minnesota	MINN. R. 2860.4400(H)	Franchisor cannot unreasonably withhold its consent if proposed transferee meets franchisor's current qualifications and standards for new franchisees.
Nebraska	NEB. REV. STAT. § 87-405	Franchisor must respond to transfer request within 60 days of notice from franchisee or request is deemed approved. Any denial must include franchisor's grounds setting forth the unacceptability of the proposed transferee and the material reasons for disapproving the proposed transferee.
New Jersey	N.J. STAT. § 56:10-6	Franchisor must respond to transfer request within 60 days of notice from franchisee or request is deemed approved. Any denial must include franchisor's grounds setting forth the unacceptability of the proposed transferee and the material reasons for disapproving the proposed transferee.
Washington	WASH. REV. CODE §§ 19.100.030(1), 19.100.180(2)(g)	Franchisor must approve or disapprove the transfer in a reasonable manner. Transfer fees are only permissible to the extent they compensate franchisors for their expenses. General releases of claims cannot contain a release of claims under the Washington Franchise Investment Protection Act.

Biographies

Jess Dance

Jess Dance is a Shareholder in Polsinelli PC's Denver office where he is a member of its Global Franchise & Supply Network practice group. His practice focuses on franchise litigation, business disputes, and other complex commercial litigation, as well as franchise disclosure and registration matters. Mr. Dance frequently represents franchisors, distributors, manufacturers, and suppliers on issues relating to registration and disclosure, defaults and terminations, contract disputes, covenants not to compete, trade secret protections, joint employment, and enforcement of trademark rights. He also advises clients in connection with franchise, distribution, and supply network transactions, contract negotiations, and pre-litigation dispute resolution. Mr. Dance graduated *summa cum laude* from Truman State University and received his J.D. *cum laude* from the Georgetown University Law Center.

Andraya Frith

Andraya is Chair of Osler's National Franchise and Distribution Practice Group, one of the most frequently recommended law firms for franchise law in Canada and an elected member of the Firm's Partnership Board. She is also Co-Lead of Osler's Retail Practice Group and Co-Founder of Osler Dash, a platform that automates the franchise disclosure and contracting process. She practices commercial law with an emphasis on retail, franchising, consumer protection, supply chain, distribution, and e-commerce law. Andraya is a trusted advisor to Canadian and International franchisors, retailers and consumer-facing businesses of all sizes operating in a broad range of industries, including financial services, consumer and commercial lending and leasing, quick service restaurants, consumer goods, pharmacy, automotive, car rental, real estate and hospitality. Andraya has developed particular expertise on advising foreign franchisors and retailers expanding their operations to Canada. She helps them maneuver through significant judicial, statutory and cultural differences between their home states and Canada to help ensure a smooth and successful entry into the Canadian market. Andraya is routinely recognized by numerous industry publications including Chambers Canada: Canada's Leading Lawyers for Business, in Franchising (Band 1) and Retail where one participant was quoted as stating, "She is off the scale effective at communication, and it almost goes without saying that she is a subject matter expert." Further she is recognized by Chambers Global (Franchising), Who's Who Legal Canada and Who's Who Legal Global Thought Leaders, Lexpert, Best Lawyers and The Franchise times in Franchise.

Sawan Patel

Sawan Patel is a Shareholder at Larkin Hoffman, located in Minneapolis. He counsels clients in a variety of matters, including entity formation, contracts, commercial transactions, mergers and acquisitions, franchising, contests and sweepstakes, and product distribution. He also counsels franchisors in structuring and operating their franchise systems by advising startup franchisors in creating franchise systems and preparing annual Franchise Disclosure Documents and registrations for established franchisors. Mr. Patel is the chair of the Young Lawyers Division Committee of the American Bar Association Forum on Franchising and the Young Lawyers Division Liaison to the Governing Committee of the American Bar Association Forum on Franchising. He is also an Associate Editor for the American Bar Association Forum on Franchising's *Franchise Law Journal*. Mr. Patel received his Bachelor of Science degrees, *cum laude*, in Honors Finance and Honors Risk Management and Insurance from the University of

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