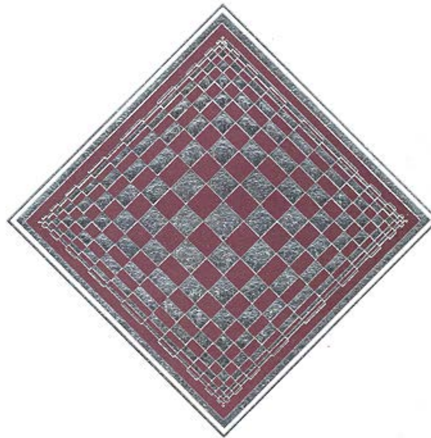

ISSUES TO BE "NEGOTIATED"

IN A FRANCHISE AGREEMENT

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<u>ISSUES TO BE "NEGOTIATED" IN A FRANCHISE AGREEMENT</u>

While all franchise agreements are not identical, you should be aware of some commonly included provisions (some of which may not apply to you) and negotiate to protect your interest. Most franchise agreements are one-side in favor of the franchisor including the lack "mutuality," that is, there are many instances when you must do or refrain from doing something, but the same is not true for the franchisor. It should be: "What is good for the goose should be good for the gander." Read the franchise agreement carefully and thoroughly and understand what it means to you. If you do not like the result – **"negotiate"** to protect your legitimate business interests.

The following comments primarily relate to the typical single-unit franchise agreement, although similar provisions exist in more complex franchise agreements such as master franchise agreements, area development agreements, area representative agreements and subfranchisor agreements.

The following are my comments to typical franchise agreement provisions explaining what the provision means and what changes are necessary to make the franchisor/franchisee relationship more equitable. These comments are arranged around major issues relating to the franchised business and the franchisor/franchisee relationship such as: (i) the right to renew the franchise: (ii) the sale of the franchised Business; (iii) the location of the franchise business; (iv) competition by the franchisor and others; (v) your financial obligations; (vi) advertising; (vii) trademarks and confidential information; (viii) product purchases; (ix) system changes; (x) default obligations; (xi) dispute resolution mechanisms; and (xii) miscellaneous matters.

<u>RENEWAL RIGHTS</u>

You do not want to buy a 10-year "rent a business" with no equity in your business and then have to get out of the business for 2 years because you are subject to a covenant not to compete. Surprisingly, most franchise agreements are structured this way, although the total length of the franchise agreement and non-compete provision varies. Here are various issues relating to your right to renew the franchisor/franchisee relationship. You will have to satisfy certain conditions to be able to renew - so negotiate to make sure that these conditions to renew are reasonable.

<u>TERM AND EVERGREEN RENEWAL RIGHTS</u>

The initial term of the franchise agreement should be long enough for you to amortize your initial investment costs (at least 10 years). The franchise agreement normally gives you a renewal right, but it is usually limited, meaning at some point in 15 to 25 years the franchise agreement terminates. I have had occasion to ask the franchisor what happens at the end of the renewal term? Surprised at the question, the candid response was "I don't know, we haven't been operating that long."

My reply was that according to the literal terms of the franchise agreement, there is no longer a legal obligation for the franchisor to renew the franchise agreement again even if the franchisee wants to. The post expiration provisions apply including possibly giving the franchisor the right to buy your franchised business at a low price, the franchisor has the right to take over your lease, phone number, customer list, and you must comply with the covenant not to compete and cease operating the business for 2 years. The effect of all of this is that you did not really buy a franchise; you "rented" a franchise business for 20 years. It makes it virtually impossible for you to resell the franchised business if there are only a few years left. At the end, like any lease, there is no

equity accumulated. You cannot sell the business or pass it down to your kids. It disappears after the end of the renewal term. Most franchisees really do not understand this. Otherwise, they may never have signed the franchise agreement in the first place.

You are buying a franchise as a long-term investment where you accumulate equity as the business grows for you to sell and retire, or pass down to your children. You should negotiate unlimited ("evergreen") rights to renew, whereby the franchise agreement is automatically renewed at your option, provided you are not in default under the franchise agreement and other reasonable conditions are met, such as the payment of a minimal renewal fee, signing the franchisor's then-current form of franchise agreement but without material changes in material business terms including not increasing royalties or other payments, not reducing the size of the protected territory and not expanding the non-competition covenants and without the execution of a general release. This way as long as the business makes economic sense you have the right to renew the franchise agreement.

NOTICE TO RENEW

Most franchise agreements require that you give written notice to the franchisor of your intention to renew the franchise agreement within a specified period, for example, within 360 to 180 days before the end of the term. If you fail to give timely written notice to the franchisor, you mat have lost your right to renew if the franchisor does not agree. Since the franchisor has staff monitoring the franchises and maintaining franchisee compliance files, you should require that the franchisor give first notice to you of the end of the term and your right to renew to prevent inadvertent oversight and loss of franchise.

RENEWAL FRANCHISE AGREEMENT

Most franchise agreements provide as a condition to the franchisor's consent to renew, that you agree to sign the "then current form of franchise agreement." Basically, you have agreed to sign whatever form of franchise agreement the franchisor shoves in front of you years from now without any opportunity to discuss and negotiate any material changes that the franchisor has unilaterally made to the agreement over the years.

The renewal franchise agreement is likely to be materially different from the one you signed years before, such as higher fees, larger and/or longer covenant not to compete, smaller or no protected territory, greater obligations on the franchisee and/or fewer obligations by the franchisor. This is because franchisors have a habit of revising (tightening) the franchise agreement after a court decision in favor of franchisees or a desire to increase the amount of income the franchisor receives from its franchisees.

You are between a rock and a hard place. If you do not sign the renewal franchise agreement, you may be forced to get out of the business for 2 years due to the covenant not to compete. Accordingly, from your perspective, the renewal franchise agreement should not be materially different from the existing franchise agreement unless collectively negotiated between the franchisor and the franchisees and approved by a majority of the franchisees.

RENEWAL (NO DEFAULT)

Many franchise agreements provide as a condition to the franchisor's consent to renew that you "shall have substantially complied with all the terms and provisions of the franchise agreement,

any amendment or successor franchise agreement, and all other agreements between the franchise and the franchisor, its subsidiaries, affiliates or divisions relating to the franchise business." Technically, with this type of language, if you have ever been in default during the term (even if timely and properly cured!), you could lose your right to renew. The unfairness of this provision is obvious. You should only have to be not in default at the time of renewal. Therefore, you need to delete this provision.

GENERAL RELEASE ON RENEWAL

Most franchise agreements have provisions stating that, as a condition to the franchisor agreeing to the renewal of a franchise, you sign and give to the franchisor a general release releasing all claims that you may have, known or unknown, against the franchisor. What if you have a valid claim and/or are in litigation with the franchisor at the time of renewal? I've seen it happen! Try to eliminate this provision or have it state that the franchisor has to give you a general release as well and further provide that the release will not include known claims and pending or threatened litigation. There are several states where this release is not enforceable. See if there is a state-specific addendum to the franchise agreement deleting this requirement. Check with your franchise attorney.

QUALIFICATIONS AT RENEWAL

Some franchise agreements provide that, as a condition to the franchisor consenting to a renewal of the franchise agreement, the franchisee must comply with the then current training and qualification requirements imposed by the franchisor on new franchisees. If you qualified for the last 10 years, why have unilateral, unknown, and possibly arbitrary, new qualifications apply? Try to have this provision eliminated.

RENEWAL (OR OPTION) FEE

A renewal fee (sometimes called an option fee) is a fee charged by the franchisor in connection with the renewal of the franchise or the option to obtain a successor franchise agreement. The fee can range from zero to a whole new then-initial franchise fee of tens of thousands of dollars. Since there are little out-of-pocket costs incurred by the franchisor in renewing your franchise (no advertising expenses, brokerage commissions, costs to find a location, costs to train, etc. that the franchisor initially incurs), negotiate to eliminate any fee or make the fee reasonable and not let it be a profit center for the franchisor.

REMODELING UPON RENEWAL

Some franchise agreements require as a condition to the franchisor's consent to renew that you remodel the premises to conform to the franchisor's then current trade dress. This could cost you tens of thousands of dollars. You should not have to remodel again if you recently remodeled. Remodeling should be subject to a capital expenditure limitation.

CONVERSION OF RENEWAL

Some franchisors that have more than one concept they franchise reserve the option to require you to change to another of the franchisor's concepts upon renewal. This really makes no business sense for you unless the original concept is dated and no longer profitable. Try to delete this provision so you have the option but not the obligation

SALE OF THE FRANCHISED BUSINESS

There may come a time when the franchisor wants to sell the System or you want to sell your franchised business. Most franchise agreements provide that the franchisor is free to sell its business including your franchise agreement to any person that it chooses (including a competitor) without your consent but you are subject to a number of conditions you must satisfy before the franchisor will consent to the sale or transfer.

SALE BY FRANCHISOR OF FRANCHISED SYSTEM

A franchise agreement may provide that the franchisor can transfer the franchise agreement to anyone it chooses without your consent. Upon transfer the franchisor is released from all further obligations under the franchise agreement. You may try to provide that the transferee (new franchisor) must have sufficient business experience, aptitude and financial resources to perform the franchisor's obligations under the franchise agreement.

The franchisor requires that the buyer of your business must meet these criteria. What impact would there be on you if a competitor acquires the franchised system such as when Popeyes Fried Chicken & Biscuits acquired Churchs Chicken? Also consider adding restrictions on the franchisor's ability to sell the franchise system to a competitor.

TRANSFER BY THE FRANCHISEE

The franchise agreement probably provides that the grant of the franchise is personal to you and you cannot transfer the franchise agreement (or a majority interest of the voting stock of a corporate franchisee) except if several conditions are met, which may include:

1. A waiver of the franchisor's right of first refusal. Make sure the franchisor's right of first refusal requires the franchisor to make up its mind to buy or not to buy your franchised unit within 10 to 30 days from receipt of the offer from the proposed buyer of your franchised unit. If it is longer than 30 days, your proposed buyer may get "cold feet."

2. The buyer's assumption of the existing franchise agreement or execution of the franchisor's latest version of the franchise agreement. Try to negotiate for an assumption of the existing franchise agreement rather than execution of a new franchise agreement.

3. The payment of a transfer fee. Make sure the fee is reasonable and merely covers the franchisor's administrative costs and the costs of training the buyer rather than be a windfall for the franchisor.

4. The execution and delivery by you of a general release to the franchisor whereby you release the franchisor from any claims you may have against it. Ask that the franchisor give you a general release as well or, better yet, eliminate the provision entirely.

Clarify that a transfer of less than a 50% interest in a corporate franchisee does not require the franchisor's consent.

RIGHT OF FIRST REFUSAL BY THE FRANCHISOR

Most franchise agreements provide that, if the franchisee receives an offer from a third party, the franchisor has the right of first refusal to purchase the franchisee's business on the same terms and conditions as contained in the third party offer. While a right of first purchase is preferable, at least make sure that the franchisor's time to exercise the right of first refusal is no more than 30 days (preferably 10 days). If it's longer, your third party prospective buyer may "cool off" and walk away while the franchisor is mulling it over. You will need to give the franchisor written notice, a copy of the contract and all other necessary information such as the financial condition and experience of the buyer for the clock to start ticking. Also provide that if the franchisor fails to give an answer, yes or no, within the time period, the transfer is deemed approved and your buyer is deemed approved

RIGHT OF FIRST PURCHASE OR FIRST REFUSAL BY THE FRANCHISOR

Under this arrangement a franchisee, upon determining that he or she desires to sell the franchise business, would approach a franchisor with specific price and terms and offer a franchisor the opportunity to purchase the franchise business. A franchisor would have a 30-day period within which it could accept or reject the proposed purchase at the designated price. If a franchisor rejects the opportunity to purchase, a franchisee would then have the right to offer the franchised business to third persons (either within or outside the franchise system) at or above the designated price. A franchisee's ability to sell to third persons should be contingent on a contract, upon no less favorable price and terms, being entered into to sell the franchised business within 120 days of the date of the first offer to a franchisor, with a closing to take place within 60 days after the date of contract.

Should a franchisee wish to offer or sell the franchise business at lower price and/or other terms less favorable to him or her within the 120-day period, a franchisee must first give a franchisor a "right of first refusal" to purchase the business at the new price and terms. Upon receiving the new price and terms from a franchisee, a franchisor would be required to accept or reject such offer within 10 days of the date of receipt of the information by notifying a franchisee, in writing, of its decision.

There should be certain exceptions to these arrangements including:

1. Transfers among existing partners or shareholders of the same franchisee;

2. Transfers among existing related corporations, partnerships, limited liability companies or other entities within a franchisee network of the subject franchisee (assuming that a franchisee owns more than one franchise business);

3. Transfers of less than a 50% interest in the entities referred to in (2) above (cumulatively over an 18 month period);

4. Transfers by a franchisee to entities in which a franchisee owns a majority of the equitable interest.

5. Transfers to a full time manager of the franchised business, provided that the manager meets the reasonable requirements for approval by the franchisor applicable to franchisees generally;

6. Transfers among family members including the spouse of a franchisee, a franchisee's children, trust or his or her spouse or children; and

7. Transfers to the "next of kin" of a franchisee.

In all such cases, a franchisor must have a reasonable right of approval (but not a right of first refusal) of the transferee so that if the family member (or entity) is unable to meet a franchisor's reasonable training and other requirements, then the transferee has the right to designate a full time general manager who could qualify to meet the requirements.

With respect to all transferee franchisees, either a franchisee or a manager approved by a franchisor must be actively engaged in the day-to-day management of a franchised business.

NEW FRANCHISE AGREEMENT BY THE BUYER

Most franchise agreements provide that, upon your sale of the franchised business, your buyer most sign the franchisor's then current form of franchise agreement rather than allowing your buyer assume your existing franchise agreement. This may kill the deal if the new franchise agreement is substantially different (more onerous) than your existing franchise agreement. Try to change this condition to the franchisor's consent to transfer to the assumption of the existing franchise agreement. What difference does it really make if you or your buyer operates the business until the end of the term of the existing franchise agreement?

TRANSFER FEE

A transfer fee is a fee charged by the franchisor in connection with your transfer of the franchise to a third party. This fee should be is intended to reimburse the franchisor for the costs of investigating and approving the transferee, legal costs and costs to train the transferee and others. Make sure the fee is reasonable in light of the obligations and services performed by the franchisor (the average is around $5,000) and is not an additional profit center for the franchisor, such as 10% of the sale price. Negotiate to provide that the fee does not apply when the transfer is by you to: (i) a corporation owned by you; (ii) a trained and qualified family member; or (iii) to another franchisee in the system. Is there a separate Transfer Training Fee also being charged? If the franchise agreement provides that the transfer fee applies when the unit is transferred to the franchisor (such as pursuant to a right of first refusal), it should be deleted as unreasonable.

TRANSFEREE'S TRAINING FEE

A few franchise agreements provide that your buyer must pay a training fee to the franchisor for the buyer's training. If this is in lieu of a transfer fee, this is fine as long as it is reasonable. If it is in addition to the franchisee paying a transfer fee, this appears to be "double-dipping" to me, unless the transfer fee is so low that it does not include the cost of training the buyer.

FRANCHISOR'S VETO RIGHT

One of the more unfair provisions that you may run into is the right of the franchisor to "veto" your sale of the franchise solely because the franchisor feels the price is too high. The buyer is otherwise qualified and all other reasonable conditions to the franchisor's consent to transfer have been satisfied. It is to be noted that you have no similar right upon the franchisor's transfer of

the franchise system. Franchisors argue that this veto right is necessary in case the buyer pays too much for the business and the debt service will make the business unprofitable. Why there may be some merit to this argument, the veto right has the adverse effect of capping the possible resale price of the franchised business and therefore capping the franchisee's equity. No franchisee wants to do this. Since the franchisor usually has a right of first refusal it can protect itself by exercising this right.

GENERAL RELEASE ON TRANSFER

Most franchise agreements have provisions which say, as a condition to the franchisor agreeing to a sale or transfer of the franchise, that you give to the franchisor a general release releasing all claims that you may have, known or unknown, against the franchisor. What if you have a valid claim and/or are in litigation with the franchisor at the time of transfer? I've seen it happen! Try to eliminate this provision or make it state that the franchisor has to give you a general release as well and further provide that the release will not include known claims and pending or threatened litigation. There are several states where this release is not enforceable. See if there is a state-specific addendum to the franchise agreement deleting this requirement. Check with your franchise attorney. One Michigan court said that franchisor could require a franchisee to drop its suit against the franchisor as a condition to the franchisor approving a sale of the business. Otherwise, the franchisor could veto the sale.

BROKERAGE COMMISSIONS DISCOUNT

If you sell your business through a business broker, you will probably be paying the business broker a brokerage fee, usually as a percentage of the gross sales price. Most franchise agreements give the franchisor a right of first refusal to purchase the business on the same terms and conditions that your third party buyer is offering. However, in this case the broker did not bring you the buyer and you probably do not owe the brokerage commission, meaning more money in your pocket. However, the franchisor wants you to reduce the amount of the purchase price by what you would have paid a broker if the third party bought the business. The unfairness of this provision is obvious. Therefore, request that the franchisor delete the brokerage commissions discount or at least split it.

CORPORATE BUYER

If you are able to have the franchisor agree that your corporation be the franchisee, you need to also provide that, if you sell the business, your buyer can be a corporation and that the principals of the corporate buyer should not have to personally guarantee the franchisee's financial obligations but be subject to the confidentiality and non-competition provisions.

RELEASE OF FRANCHISEE UPON TRANSFER

Most franchise agreements provide that, upon assumption of the franchise agreement by your buyer, you are not released from your future obligations under the franchise agreement. If your buyer fails to perform, you are liable. This is similar to selling a house and having your buyer assume your mortgage. You should not remain liable for your buyer's obligations under the franchise agreement after you sell. You should be released just like the franchisor is released if it sells. Make sure this provision is included in the franchise agreement.

Remodeling Upon Transfer

Some franchise agreements require as a condition to the franchisor's consent to transfer that you remodel the premises to conform to the franchisor's then current trade dress. This could cost you tens of thousands of dollars and may kill your deal. You or your buyer should not have to remodel again if you recently remodeled. Remodeling should be subject to a capital expenditure limitation.

Subordination of Seller Financing

The franchise agreement may provide as a condition to the franchisor's consent to a sale of the franchise business, if you sell the franchise business, any purchase money financing you give to the buyer must be subordinate to the buyer/franchisee's monetary obligation to the franchisor. This should be limited to purchase money financing provided by the franchisee/transferor and not to third party (bank) financing.

LOCATION OF THE FRANCHISED BUSINESS

Location of Your Franchised Business

Is your unit at a fixed location (for example, store) or is it mobile (for example, cart)? If mobile, can you go anywhere? If fixed, can you relocate if you lose your lease through no fault of your own or if the building is destroyed or taken by eminent domain (for example, condemnation)? Must you operate only at this location? What about home delivery? Can you market outside your trade area by direct mail, catalog, (800) number, etc.?

Lease of Business Premises

The franchisor usually requires that it must approve the location of the premises and the lease between the franchisee and the landlord. The franchise agreement may, particularly for a retail-based franchise concept, have provisions requiring that the franchisee to make sure certain terms required by, and for the benefit of, the franchisor are included in the lease such as making a default under the franchise agreement a default under the lease entitling the franchisor to take over your lease.

Use of Premises

Many franchisors require that you include a provision in your lease that limits your use of the premises to operating that particular franchise. This precludes you from operating a similar independent business if you choose to go independent upon expiration and nonrenewal of the franchise agreement or upon termination of the franchise agreement due to the franchisor's default. You should be allowed to operate a similar business under a different name at the same location if the franchise agreement expires and is not renewed or if it is terminated by you due to franchisor's default. You will need to revise this provision.

Relocation Rights

There is always a chance you lose your right to operate the franchise business at the business premises due to a number of factors beyond your control including condemnation, casualty and loss of lease. Make sure that the franchise agreement provides that if one of these events occurs, you have a

reasonable period of time to relocate the franchise business to a new location without forfeiting your franchise. Will minimum royalties, advertising contributions and other payments abate (stop) during this period? Does the franchisor charge a relocation fee? Ask about the franchisor's relocation policies. Get it in writing and renegotiate it if it appears unreasonable from your perspective.

RESERVED LOCATIONS

The franchisor may reserve the right to locate additional or special outlets(for example, kiosks or "express" units) in your exclusive or protected territory. While it is best to eliminate this right, at the very least you should have a right of first refusal to own and operate these additional outlets if within your exclusive or protected territory.

INSPECTION

The franchisor normally has the right to inspect your business and records to make sure you are operating in accordance with the franchise agreement and system standards without prior notice to you. You may want the franchisor to give you prior notice but the franchisor may not want to do this because an unannounced inspection may be more effective. In any event, you should provide that the inspections be done discreetly without interrupting your business. In addition you should reserve the right to videotape the inspections, that you be given a copy of the inspection report and that you can retain a portion of any sample taken by the franchisor's inspector.

The franchisor may also want to show your business to prospective franchisees. Don't allow your franchise business to become the franchisor's training facility or "show case" unit without reasonable compensation to you.

COMPETITION BY FRANCHISOR AND OTHERS

A major problem in franchising today, primarily in large systems, is having more outlets in a market than the market can handle ("over-saturation"). In addition, with the explosive growth of "branding" (major brand names, many of whom are franchise systems, opening on college campuses, airports, highway facilities, hospitals etc., that is, "non-traditional locations"), new opportunities have arisen. Unfortunately, some of these non-traditional locations are within existing franchisees' trade areas and sales at the franchise locations decline as customers are diverted to the new non-traditional locations, usually owned by the franchisor ("cannibalization"). That is why it's so important in most franchise systems to have an exclusive or protected territory.

EXCLUSIVE OR PROTECTED TERRITORY

Do you get an exclusive territory within which the franchisor or another franchisee can't operate (for example, 3-mile radius or 30,000 households)? Does the territory constitute a sufficient market from which the franchisee can make a reasonable rate of return on investment? Should not other demographic factors be considered be considered in defining a reasonable and realistic exclusive or protected territory? Note that the Franchisor usually requires the covenant not to compete area to be substantially larger.

Is your exclusive territory dependent on your achieving a certain sales level? Can the franchisor unilaterally reduce your territory? Try to get an exclusive territory that is reasonable for your trade area. Don't accept a "location only" (no exclusive territory) provision. If you do, the

franchisor may (if it expressly reserves the right) open a company outlet or franchised outlet across the street or next to you that will cannibalize your sales.

Does the franchisor reserve certain rights to operate directly within your exclusive territory, such as sales to supermarkets, catalog sales, national accounts, the Internet, etc. without your consent or participation and thereby compete with you (encroachment)? If so, can you eliminate this and develop a "win-win" scenario by participation in the alternate distribution method. This issue should be disclosed in ITEM 12 of the FDD.

The Internet is having a profound effect on changing how goods and services are marketed and sold. Certain channels of distribution will inevitably be eliminated. Is it possible for the franchisor to deal and services customers directly, even the ones in your trade area? You should examine this issue.

CUSTOMER RESTRICTIONS

Does the franchise agreement limit the type or class of customers (for example, residential and not commercial; retail and not wholesale) with whom you can do business? A franchisor must disclose this in ITEM 16 of the FDD. If there are restrictions, what are their business justifications? Are they reasonable? Does the franchisor get the gold mine and you get the shaft? If you think they are unreasonable -- renegotiate.

SALES RESTRICTIONS

Are there restrictions on the types of products you can sell? Can you sell outside your location, such as home delivery? Can you solicit business outside your exclusive territory, such as by way of an 800 number, advertisement or catalog sales? Can you operate outside your territory in an area where there is not another franchisee (a “Greenfield)? These restrictions will be enforced by the courts if they are clear and unambiguous in the franchise agreement and properly disclosed in ITEM 12 of the FDD.

What impact does the Internet have or will have on the business? This issue will continue to be fertile ground for disputes between franchisors and their franchisees as franchisors attempt exercise total control over the system’s web sites and try to market directly to customers including customers traditionally serviced by franchisees.

These issues need to be examined and probably renegotiated to make it a “win-win” for the both the franchisor and its franchisees.

FRANCHISOR’S RIGHT TO COMPETE WITH YOU

Even if you are granted an exclusive or protected territory, there may still be provisions allowing the franchisor to compete with you in some way. If these rights are specifically reserved by the franchisor in the franchise agreement and disclosed in ITEM 12 of the FDD, the courts will respect these reserved rights even if the exercise of these rights by the franchisor causes you harm. Therefore, you need to limit the franchisor’s right to compete, directly or indirectly, with you in your territory without your consent and participation.

NATIONAL ACCOUNTS

If the franchise system sells its products or services to national accounts, the franchisor probably has reserved the right to deal with these national accounts directly, even where a branch of the national account is located within the exclusive territory of the franchisee. There are legitimate reasons for this including the desire of the national account for uniform pricing and a desire to deal with only one person. You should, however, have the franchisor give you the right to service these national accounts, where branches are located within your exclusive territory, on terms mutually agreeable to you and the franchisor.

MINIMUM PERFORMANCE REQUIREMENT

Some franchise agreements, particularly if an exclusive or protected territory is granted, condition the grant of the franchise and/or the exclusive territory to your achievement of a certain level of sales. It would be best not to have a minimum performance requirement in the franchise agreement. If it stays in, make sure the minimum performance requirement is reasonable and easily achievable by you with a reasonable (not superhuman) effort. The performance standard should separate the "Ds" from the "Fs," not the "As" from everyone else. The penalty for not achieving a reasonable performance requirement should be some reasonable monetary penalty, or reduction or loss of exclusivity - not the loss of the franchise.

RIGHT OF FIRST REFUSAL BY THE FRANCHISEE

You may want certain rights of first refusal to purchase such as to purchase an additional franchise in an adjacent territory, or where the franchisor has reserved the rights to open additional outletsin your exclusive or protected territory. If you do, negotiate it in the franchise agreement as a separate agreement. Make sure you have sufficient time to exercise it once it materializes. The time period should not be any shorter than any right of first refusal given to the franchisor.

FINANCIAL OBLIGATIONS

A person purchasing a franchise is making an enormous financial investment and taking on long-term financial obligations under the franchise agreement, any real estate lease and any bank financing. While these transactions normally require a personal guaranty, you should always attempt to limit your personal liability through the formation of a business entity (*e.g.* corporation) that has limited liability for its equity owners (*e.g.*, shareholders). You need to understand all of your financial obligations including your long-term obligations to the franchisor under the franchise agreement.

FRANCHISEE (INDIVIDUAL VS. CORPORATION); PERSONAL GUARANTY

Most franchisors want you and your spouse, individually, to sign the franchise agreement or will allow your company to sign the franchise agreement provided you and your spouse personally guarantee. This is so that you and your spouse are personally obligated for the franchisee's obligations to the franchisor under the franchise agreement including unpaid royalties, unpaid product purchases, indemnity obligations, etc. Try to have the franchisee be your corporation. Try to negotiate out your personal guarantee. Offer that you and your spouse will sign personally a confidentiality and non-compete agreement. Your ability to do this may depend on the financial strength of your corporation. If a personal guarantee is required, try to limit it to the first year or two of the franchise agreement.

Don't have your spouse also sign the guarantee. This may expose most of your joint personal assets. In all likelihood, none of the franchisor's principals give you a personal guaranty of the franchisor's obligations to you.

FINANCING CONTINGENCY

If you are obtaining a loan from a bank or other lender to be used to purchase the franchise and the business assets after the franchise agreement is signed and you have paid the initial franchise fee, you will want to include a financing contingency so that if the loan does not materialize for any reason, you can receive a refund of the initial franchise fee. Otherwise the language of the franchise agreement provides that you forfeit all of a portion of the initial franchise fee if you fail to timely open the franchised business.

INITIAL FRANCHISE FEE

Most franchisors charge an initial franchise fee, which is to reimburse the franchisor for its costs involved in creating the franchise, legal and accounting expenses, marketing the franchise, and in training you and in helping you become operational. The reasonableness of the initial franchise fee depends on the value of the benefits you are receiving in return. If you are short on capital, try to negotiate installment payments of defer a significant portion until you become operational.

ESCROW OF INITIAL FRANCHISE FEE

You may be paying the franchisor tens of thousand of dollars upon signing the franchise agreement - several months before you open the business. Particularly if the franchisor is new or does not have a strong financial statement, negotiate to have your funds held in escrow until the franchisor completes its pre-opening obligations to you. Some of the franchise registration states may issue an impound order which requires an "under-capitalized" franchisor to escrow these funds for all sales in, or to residents of, that state until the franchisee opens for business as a condition of the state's approval of the franchise registration. It would be a prudent act, regardless of the size and nature of the franchisor; to have your up-front payments escrowed.

GROSS REVENUES

Nearly all franchise agreements have a special definition of what constitutes gross sales, gross receipts or gross revenues. Read the definition very carefully to make sure that, if you have revenues from other activities not associated with the franchisor's trade name, these revenues are outside the definition so you don't pay royalties on these revenues. Furthermore, make sure there is excluded from the definition of gross revenues "phantom" income such as sales tax collections, shipping and handling charges, customer credit and refunds, revenues from employee meals, etc. If the franchisor otherwise receives a portion of the revenues such as a commission or a split, it would be unfair not to at least compute the royalties on the net income to the franchisee after the payment of the commission or split. Even in this situation there is "double dipping."

If you are already operating a similar business and are a conversion franchisee, you want to negotiate that the royalty will be paid on the incremental (increase in the amount of) revenues and not on the existing book of business.

Minimum Royalties, Advertising Contribution or Other Payments

The problem with minimum payments, (a floor below which a percentage of gross revenues will not fall) is that it costs you excessive fees when your sales are low, such as when you are starting up or in a bad cycle. For example, an ice cream franchisee must purchase at least 10,000 gallons of ice cream mix from the franchisor per year. However, the average franchisee uses only about 6,000 gallons per year. The minimum royalty thus becomes 167% of what the royalty should be. Some "minimum!" What about putting a maximum amount on these fees? What about delaying the minimum for a period of time until you are fully operational? Try to eliminate minimum fees, unless they equate to the value of any minimum services you receive from the franchisor.

Electronic Funds Transfer

In today's "paperless economy" many payments are made electronically. Franchisors have picked up on this and, not wanting to hear "the check is in the mail," require that payments made by the franchisee to the franchisor such as royalties and advertising contributions be made electronically. Many new franchise agreements require that the franchisor and franchisee establish an automatic payment system through a financial institution such as electronic funds transfer or use of special checks, whereby the franchisor can access the franchisee's bank accounts for royalties, advertising contributions and other payments. Many franchisees find this intrusive. There are practical ways around it such as using cash management to "sweep" your operating account (accessible by the franchisor) keeping minimal balances and transfer the funds into your savings account (not accessible by the franchisor).

Late Charges

Most franchise agreements provide that if you are late (usually after a period of time) in paying the royalty, advertising contribution or other payment to the franchisor, a late charge will be imposed on top of the payment. The late charge can be very small or very large. The time period can begin immediately or up to a grace period of 10 days. Try to include a 5 - 10 day grace period before a late charge is imposed. Try to negotiate out a percentage charge (for example, 5%) or a fixed fee (for example, $100.00), which can be excessive in favor of an interest charge.

Application of Payments

Generally, franchisees will pay royalties that belong to the franchisor and advertising payments that the franchisor holds on behalf of the franchisees. Usually, when a franchisee becomes delinquent to the franchisor, both royalties and advertising fees are owed. Too, often, when a franchisee gets into trouble, and then makes a payment to the franchisor, the franchisor will apply the funds first to royalties and then to advertising contributions rather than apply the payment pro rata to royalties and advertising contributions. This sometimes results in the franchisor being made whole at the expense of the Advertising Fund, with the franchisees suffering the loss or having to make up the difference in some way. Have the franchisor agree that all payments made by any franchisee or other person specifically payable to the Advertising Fund or Cooperative must be deposited into the Advertising Fund or Cooperative and not against such franchisee's unpaid royalties or other payments. If a franchisee is delinquent in the payment of royalties and advertising contributions, any amounts collected by the franchisor will be proportionately allocated to royalties and advertising contribution and not first to all unpaid royalties.

SECURITY INTEREST

As security for your obligations to the franchisor under the franchise agreement, are you required to give the franchisor a security deposit or grant the franchisor a security interest or provide a letter of credit? If you grant a security interest, try to limit it to the products purchased. If you must grant a security interest in your business assets negotiate to have the franchisor agree to subordinate (stand behind) its security interest to: (i) your landlord's lien; (ii) the security interest of a reputable institutional lender for a loan to the franchisee for working capital purposes; (iii) to purchase money security interest of an approved equipment vendor for any equipment purchased or leased by the franchisee and used in the operation of the franchise business; or (iv) to purchase money security interest of a supplier of approved products sold at the franchise business.

GROSS UP FOR TAXES

Several years ago the South Carolina Supreme Court allowed the State of South Carolina to tax royalty payments made by a South Carolina franchisee to an out-of state-franchisor. Several other states are taxing or looking into taxing royalty payments made by its state franchisees to out-of-state franchisors. Some heavy-handed franchise agreements provide that the franchisee will pay as additional royalties the taxes associated with the franchisor's royalty receipts. This may become a significant concern when more states attempt to tax royalty payments paid by franchisees to out-of-state franchisors and require the franchisee to withhold and remit such taxes on behalf of the franchisor. This would have the effect of increasing the true amount royalty rate. You should not have to pay more than the royalty set forth in the franchise agreement. If a franchisee is obligated by a state to withhold taxes on royalty payments, this should be credited against the royalty payments due the franchisor, as it will receive a state tax credit against its U.S. income taxes.

FRANCHISOR'S MANAGEMENT FEE

A franchise agreement may contain a provision that if the franchisor takes over the management of your business (for example, due to your disability), you will pay to the franchisor the costs of the manager or other employee appointed by the franchisor to manage the business on behalf of the franchisor for your mutual benefit. This is not an unreasonable provision. But sometimes, the franchise agreement also provides that you will pay the franchisor a management or administrative fee on top of a manager's salary. This would appear to be excessive unless real value is given.

LIQUIDATED DAMAGES FOR UNAUTHORIZED PRODUCTS OR SERVICES

A liquidated damages provision provides that if you do something wrong, like sell unauthorized products or services, you must pay the franchisor certain specified damages in lieu of the franchisor having to prove its actual damages. If this provision is in the franchise agreement, make sure it is reasonable. Some states (for example, New York) may not enforce it.

LIQUIDATED DAMAGES UPON TERMINATION

This type of liquidated damages provision provides that if you default under the franchise agreement and the franchise is terminated, you must pay the franchisor certain specified damages for the franchisor's lost profits through the end of the term, in lieu of the franchisor having to prove its actual damages. If this provision is in the franchise agreement, make sure it is reasonable. Some states (for example, New York) may not enforce it.

INDEMNIFICATION

Generally, this language is drafted in a completely one-sided fashion. Guess in whose favor? The franchisee fully indemnifies the franchisor for all liability of any form or fashion. At a minimum, the franchisor must indemnify you and your agents, employees and contractors from any action or inaction on the part of the franchisor, its agents, employees, or contractors based on negligence or a willful act that results in a claim, suit, demand or judgment for liability. If the franchisor or its affiliates sell products or services to you, they need to provide you a warranty of these products or services.

REPORTING REQUIREMENTS

The franchise agreement may normally provide, particularly if you pay royalties as a percentage of gross revenues, that you supply the franchisor with copies of your sales records, including sales tax returns, if any. The franchisor will also normally require you to supply monthly and/or quarterly financial statements (balance sheet, profit and loss statement and statement of cash flows) prepared and certified by you as well as year-end financial statements prepared by an independent certified public accountant. Make sure you have at least 45 days from the end of each quarter and 90 days from the end of each year to supply these statements. Also, very importantly, make sure that the year-end financials are "compilation" statements (preferable) or "review" level statements (next preferable), but definitely not "audited" financial statements. The reason for this is that the cost of audited financial statements is several thousand dollars more than compilations. Only if you are caught under-reporting should audited statements be necessary.

AUDIT BY FRANCHISOR

In franchise agreements where a royalty fee is based on the amount of the franchisee's gross revenues, the franchisor has the right to audit the franchisee's books and records. Further, if the audit reveals an underreporting by the franchisee, the franchisee bears the cost of the audit. Make sure you limit the frequency at which audits can be done (to prevent harassment) and that the underreported amount is significant (2% - 5% of gross revenues) and intentionally underreported, and not due to an honest mistake, in order for you to be responsible for the franchisor's audit costs.

FRANCHISEE'S FINANCIAL STATEMENTS

The franchise agreement will probably require you to give the franchisor monthly, quarterly and/or annual financial statements relating to the franchised business. Monthly and quarterly financial statements are usually prepared internally by the franchisee and do not have to be prepared by an accountant. When it comes to the year-end financial statements an accountant will be required to prepare them.

There are 3 levels of financial statement reporting - compilation, review and audited. Each is more extensive and more expensive. Compilation statements are typical for most small businesses. If the franchise agreement requires audited financial statements from the beginning of the relationship, it will cost the franchisees several thousands of dollars per year unnecessarily. The franchise agreement should provide for compilation statements prepared by an independent certified public accountant and certified as correct by the franchisee, at least until there is evidence of underreporting.

Confidentiality of the Franchisee's Information

There are numerous provisions in a franchise agreement giving the franchisor the right to examine and copy your records and requiring you to provide financial and other information about you and the business. You do not want to allow the franchisor to share this information with third parties without your consent. Make sure that the franchise agreement provides that the franchisor will keep your financial records and other information confidential except as may be required by law including for use to compile an earnings claim to be contained in the FDD.

Right of Set Off

A right of set off is the right to deduct amounts due you from the franchisor from amounts you owe the franchisor such as royalties. This provision is extremely difficult to get as most franchise agreements specifically provide that the franchisee's obligations to pay royalties and other payments are independent of any obligation of the franchisor to you. In addition, the courts have uniformly held that, unless the franchise agreement provides to the contrary, a franchisee cannot accept the benefits of the franchisor's trademark (by continuing to operate under the trademark) without paying royalties, even where the franchisee may have valid claims against the franchisor. You must keep paying royalties and file a separate suit.

Therefore, you should try to negotiate for the optional ability to perform the obligations of the franchisor under the franchise agreement upon the franchisor's failure or refusal to perform and to set off any sums expended against the royalties or other monetary obligations under the franchise agreement. In many instances this will be your only sufficient remedy if the franchisor fails to perform. The franchisor should be afforded reasonable notice and an opportunity to cure before your being able to exercise this right.

Acceleration of Royalties

Many franchise agreements contain language allowing the franchisor to accelerate and make immediately due and payable the total royalties that would have been paid for the remaining term of the franchise agreement following its premature termination due to the franchisee's default. If this provision exists, insist on its deletion, as any acceleration could prove costly to you. If you can't eliminate it entirely, reduce it to a specified period of time (for example, 3 years) and also apply a present value discount factor (for example, 8%), since a dollar payable a year from now is worth less than a dollar if prepaid today. If the franchise agreement contains a liquidated damages clause on premature termination, insist upon its deletion, unless it is reasonable. (See **Liquidated Damages** below). Even without such language if you breach the franchise agreement and abandon the franchise business or covert it to an independent business in violation of the covenant not to compete, you may be liable for damages to the franchisor including lost profits in the form of all future royalties until the end of the term of the franchise agreement. This is why this provision is so important. (See **Future Royalties** below.)

Securities Offerings

Many single-unit franchise agreements do not address this issue and, therefore it may not be a concern for you. However, some franchise agreements and most area development agreements prohibit or severely restrict a franchisee from raising capital through a private or public securities offering. If you have a capital-intensive franchise or you are an area developer (multi-unit franchisee), you may want to reserve the right to raise capital through the sale of securities. The legitimate

business interest of the franchisor in this regard is to have the right the review the offering materials before public dissemination to make sure they fully and accurately describe the relationship between you and the franchisor so that the franchisor will not have any liability arising from your securities offering. A reasonable offering fee charged by the franchisor to you to reimburse the franchisor for its actual costs in this regard including attorneys' fees is fair. Any right of first refusal should run concurrently with the securities review period.

ADVERTISING

One of the purported advantages of being part of a franchised system is that having a number of outlets operating under a common trade name creates greater brand recognition among consumers. In addition, there usually exists an economy of scale in advertising by having a number of outlets in one advertisement rather than just one unit. In most franchised systems there exists 3 levels of advertising: (i) local - by a single franchisee in his or her local market; (ii) cooperative- by a group of franchisees in a given market; and (iii) regional and national - through contributions by the franchisees to an advertising and marketing fund administered by the franchisor. This marketing fund can having thousands of dollars contributed to it.

LOCAL ADVERTISING OBLIGATIONS

Recognizing the importance of advertising, the franchisor will probably require you to spend a percentage of your gross revenues on local advertising, which you will place directly in your local market using marketing materials developed by the franchisor.

COOPERATIVE ADVERTISING

In a single advertising market (Designated Marketing Area or DMA) where 2 or more franchised outlets are located, there may be created advertising cooperative to economize on the cost of advertising. The franchise agreement will usually provide that payments to a cooperative are credited against your local advertising obligations. A local advertising cooperate makes good sense and can save everyone money. However, specifically provide that the personal liability of each franchisee for the obligations of the cooperative be limited to the franchisee's *pro rata* share (based on the number of outlets in the cooperative) of the payments made or otherwise due the cooperative under the franchise agreement but are not paid. Have the franchise agreement provide that, upon request of more than 50% of the outlets comprising a cooperative, the franchisor will take over and manage the cooperative.

ADVERTISING BY THE SYSTEM (REGIONAL AND NATIONAL)

You will probably be required to contribute to a regional or national marketing fund, controlled by the franchisor, for regional or national advertising such as television commercials and ads in national publications. In most franchise systems, national and regional advertising programs are administered solely by the franchisor spending money contributed by the franchisees in the form of advertising contributions (the "Marketing Fund"). In larger systems, this is multi-million dollar fund. In addition, the success of advertising is sometimes difficult to ascertain. There is this old joke made by advertising executives who say: "I know that 50% of my advertising budget is effective, I just don't know which 50%."

Make sure that, if there is a regional or national marketing fund administered by the franchisor, all the funds are considered trust funds used solely for advertising the products or

services offered by the system and are not used for promoting the sale of additional franchises or for any other purposes. A reasonable administrative fee may be charged by the franchisor if the franchisor in fact is administering the fund and providing services. Have the franchisor be a fiduciary to you regarding these funds. To prevent "free riding," make sure that the franchisor's company outlets are obligated to contribute and advertise to the same extent as a franchisee. ITEM 11 of the FDD should discuss these issues in detail.

Ideally, the franchisees should be involved in the decision-making process as to the type of advertising, the advertising budget and amount of advertising contributions. This could benefit the franchisor as well, particularly a franchisor having few or no company-owned outlets feeling the pulse of the marketplace. In addition, having franchisee-input will reduce the amount of Monday-morning-quarterbacking that goes on, especially with ineffective campaigns. The National Advertising (Marketing) Fund should be administered by a committee composed of the franchisor's and the franchisee association's representatives. Have the fund audited annually by the franchisor's accountants with a copy given to each franchisee.

APPROVAL OF ADVERTISING

The franchisor, as owner of the trademarks, reserves the right to approve the franchisee's advertising materials before the franchisee advertises to make sure the marks are being used properly. This is entirely permissible. In fact, the trademark laws require a trademark own to "police" its marks. The franchisee must submit its advertising materials to the franchisor for approval unless previously submitted and approved by the franchisor or is solely based on materials provided by the franchisor. The issue boils down to how much time does the franchisor have to review your materials? A 7 to 10 business day period is often set forth. If a longer period is set forth such as 30 days, try to have it reduced.

ADVERTISING FUND FINANCIAL REPORTS

Regardless of who administers the Advertising Fund, to assure accountability in the administration of the Advertising Fund, the franchisor's auditor, at the expense of the Fund, should audit the financial statements of the Advertising Fund annually. Audited reports should be given to each franchisee within 120 days of the end of each fiscal year.

FIDUCIARY RELATIONSHIP

As a general rule, parties to a contract do not have any special duty to one another beyond complying with their contractual obligations. There is no special relationship of trust, confidence or responsibility such as a trustee has to its beneficiaries. At an minimum, there should at least be a fiduciary relationship between the franchisor and its franchisees relating to advertising funds paid by the franchisees to the franchisor since these funds are the property of the franchises and are intended to used for a particular purpose. This will undoubtedly have to be specifically included in the franchise agreement.

TRADEMARKS AND CONFIDENTIAL INFORMATION

One of the cornerstones of a franchise system is a well-recognized trade name (for example, McDonald's®). The right to operate under the franchisor's trade name is one of the reasons you are willing to pay an initial franchise fee and ongoing royalties. The franchisor may also have trademarks, copyrights, patents, trade secrets and other confidential information that are valuable assets used by

the franchisees. This intellectual property and proprietary information needs to be protected from use by unauthorized parties.

TRADEMARKS

Have the franchisor warrant its ownership of the trademarks in the franchise agreement. In addition, make sure that the franchisor really does own the name and has obtained, or is in the process of obtaining, a U.S. registered trademark. (Item 13 of the FDD discusses the franchisor's rights to the trademarks licensed to the franchisee). If the franchisor changes its trade name, provide that the franchisor will reimburse you for your costs in new signage, stationery, business cards, paper goods, etc. Also, add a provision that the franchisor will do nothing which will dilute the value of the trademarks, such as selling inferior products, using inferior ingredients, selling frozen items instead of fresh (if the latter was the system's market position), etc.

In many franchise systems an affiliate of the franchisor or other third party actually owns the trademarks, the manuals and the system and licenses them to the franchisor. The franchisor is given the right to sublicense and loan these items to the franchisee under a license agreement between the trademark owner and the franchisor. This should be disclosed in ITEMS 1 and 13 of the FDD. What happens to your right to use these items if the franchisor defaults under the license agreement with the affiliate? Is the affiliate obligated to assume the franchisor's obligations to you? Can you continue to use these items? These issues need to be addressed to your satisfaction.

TRADEMARK INDEMNIFICATION

The franchisor should warrant ownership of the marks and indemnify and reimburse you for any damages you sustain if a third party brings a trademark infringement action against you provided you were using the marks consistent with the terms of the franchise agreement. Make sure that, if you are sued for trademark infringement by a third party for using the franchisor's trade name pursuant to the franchise agreement, the franchisor indemnifies you and holds you harmless for any damages sustained by any third party, including court costs and attorneys' fees.

MODIFICATION OF TRADEMARKS

Most franchise agreements provide that the franchisor reserves the right to modify the trademarks. This can have significant repercussions to you in terms of the loss of goodwill associated with the old trademarks and the changeover costs. At a minimum, have the franchisor reimburse you for your costs of changing the name such as signage, stationary, business cards, etc.

ANTI-DILUTION

You pay an initial franchise fee and royalties based in part on the perceived value of the franchisor's marks. What if the franchisor's actions contribute to a reduction in the perceived value of the trademarks, such as a unilateral change in market niche or a reduction in the quality of the goods? This may have the effect of lowering the value of your franchise. Add a new provision that the franchisor will not do anything to cause a dilution in the value of the Proprietary Marks. A similar provision is usually imposed upon you, so ask that it be made mutual.

MANUALS

Not everything you agree to with the franchisor is in the franchise agreement or disclosed in the FDD. You also agree in comply with the terms of the Manuals. The terms of the Manuals are considered terms of the franchise agreement under which you are bound, although not disclosed in the franchise agreement or FDD due to their confidential nature. This is because most franchise agreements provide that the terms of the Manual are "incorporated" into (become a part of) the franchise agreement. The Table of Contents of the Manuals is usually included in ITEM 11 of the FDD, unless you are afforded an opportunity to examine the Manuals before you sign the franchise agreement. Most franchisors elect to include the Table of Contents. The franchise agreement will also contain a provision whereby you acknowledge having reviewed or having an opportunity to review the Manuals. Have you reviewed them? I would recommend that you do.

REPLACEMENT COST OF MANUALS

Most franchise agreements provide that, if your copy of the manuals are lost, stolen or destroyed, the franchisor will supply a replacement copy. Make sure a specific and reasonable amount for the replacement copy is set forth in the franchise agreement.

CONFIDENTIALITY OF THE FRANCHISOR'S INFORMATION

There will be provisions in the franchise agreement requiring the franchisee to keep the franchisor's proprietary information and trade secrets confidential such as the information contained in the manual. If you have prior experience in the business before becoming a franchisee, you may want to consider clarifying what this means.

The franchisor will also require in the franchise agreement that the franchisee must have its managers and certain or all other employees sign a confidentiality, noncompetition agreement, (similar to the franchisee's covenants contained in the franchise agreement), as a condition of employment. This is intended to protect the franchisee and the franchisor from unfair competition and disclosure of confidential information. This is fine as long as the scope, geography and duration of the covenants are reasonable. Ask if the franchisor provides a form and review a copy of it.

CUSTOMER LISTS

A customer list may be a valuable asset. Your franchise agreement may provide that a copy of your customer list must be given to, and is the property of, the franchisor. Try to change this to specifically provide that you continue to own your customer list. Alternatively, provide that the franchisor can't use your customer list to compete against you (for example, the franchisor sending a direct mail piece directly to your customers and you're not involved).

FRANCHISEE'S IDEAS

Most franchise agreements provide that any ideas that a franchisee comes up with to improve the system must be submitted to the franchisor for approval before the new idea can be used by the franchisee. If the franchisor agrees with the idea it becomes the property of the franchisor and the franchisee gets no benefit other than the right to use the idea into the business. A fairer approach is to provide that the ideas remain the property of the franchisee who is obligated to license the ideas to the franchisor and the other franchisees for a fair license fee if approved for use in the system.

Goodwill

In my mind, there is more than one type of goodwill associated with a franchise business. First and foremost is the good will associated with the franchisor's trademarks and system. However, secondarily but importantly, is the local goodwill created by the franchisee's local marketing efforts and service to the customers in the local trade area. This local goodwill is a valuable asset of the franchisee and part of the fair market value of the franchise business and part of the purchase price when the franchisee sells the franchise business.

Most franchise agreements provide that all goodwill associated with the trademarks and the system belongs solely to the franchisor. While the following may be implied it is better to add that this provision does not prevent the franchisee or its approved buyer from allocating a portion of the sale price to goodwill in connection with an approved sale of the franchise business and will not adversely affect the valuation of the franchise business on an ongoing business basis.

PRODUCT PURCHASES

In many franchise systems, you must purchase certain products or services from the franchisor, its affiliates or designated suppliers. Hopefully, the prices for the goods and services are lower than if you were not part of the franchise system due to the economies of large purchasing. However, some franchisors use the franchise agreement as an opportunity to engage in excessive pricing. This has to be prevented.

Purchases from Franchisor; "Most Favored Nations" Clause

If you are obligated under the franchise agreement to buy all or any portion of equipment, inventory or other products or services from the franchisor or an affiliate, you are locked in. It's like dealing with the utility company but with no public service commission to hold them in check. You need to prevent the opportunity of price gouging. You need to determine how the wholesale price is arrived at. The franchisor is certainly entitled to make a reasonable profit on the sale of these items. What is the pricing formula? On what basis can the franchisor increase prices? Clarify these pricing issues. What if the products are not available? (Remember the oil crisis.) Can you purchase directly from the manufacturer or purchase comparable products.

Also negotiate a provision whereby you receive the most favorable pricing terms available to any customer for these items (a "most favored nations" clause).

Royalties on Sales of Products Purchased from Franchisor (Double Dipping)

If you paid a wholesale price for the products sold by the franchisor, there is an element of profit to the franchisor for the sale. If the franchisor then imposes a royalty on your resale of the products to your customer, the franchisor has benefited twice or double dipping. Either buy at the franchisor's cost or carve out sales of products purchase from the franchisor from the computation of gross sales.

Insurance by the Franchisee

Give or fax a copy of the insurance provisions contained in the franchise agreement to your insurance agent. There are now insurance agencies that specialize in insurance for franchisees. An

agent needs to review this to determine what types of insurance are required, amount of coverages, deductibles, etc. Have your agent determine if the requested insurance is reasonable and necessary for your business and how much it's going to cost you annually. For example, some franchise agreements require business interruption insurance, which is expensive and may not be obtainable for a start-up. Your agent must also deliver a certificate of insurance to the franchisor naming the franchisor as an additional insured and/or loss payee (depending on the type of insurance) and provide 10 - 30 days' prior written notice of a change or cancellation of the insurance.

PRODUCT LIABILITY INSURANCE

If you purchase products from the franchisor or its affiliate, provide that the franchisor or its affiliate will obtain and maintain adequate product liability insurance relating to the products sold to franchisees and naming the franchisees as additional insureds. (See **INSURANCE BY FRANCHISOR** above.)

PRODUCT WARRANTIES

Make sure the franchise agreement provides for a product warranty on all products manufactured by the franchisor or its affiliates, a "pass-through" of all warranties from third party manufacturers, as well as maintenance of adequate product liability insurance.

VENDORS

Sometimes there is a provision making it an event of default under the franchise agreement if you are in default in the payments to your vendors. There is some rationale for this provision in that there may be vendors crucial to the system where non-payment to whom may adversely affect the franchisor and the other franchisees in dealing with the same vendor. It would be best to limit this provision to certain vendors important to the System, add a dollar threshold and exclude bona fide disputes.

SYSTEM CHANGES

There probably will be changes required to the system due to changes in the market place such as changes in demographics, competitive circumstances, population and technology. Most businesses require additional investment over the years for refurbishment, renovation, repairs, upgrades, and new equipment. Franchisors understand this and put provisions in the franchise agreement allowing the franchisor make changes to the manual which you must adopt, requiring you to make all necessary refurbishment, renovation, repairs, upgrades, new equipment and technology etc. A problem can develop if these changes come too often (the franchisor's "idea du jour") and/or are extremely expensive. In addition, many franchisees would rather increase the amount of money that take from the business rather than create reserve accounts. This may result is the franchisee not having cash available when necessary capital expenditures are required.

CAPITAL EXPENDITURE LIMITATION

A proper balance between the franchisor's desire for necessary change and your inclination not to spend is to agree to the frequency of the changes and the maximum capital amount that must be spent as determined by the franchisor without your consent, such as no more than $50,000 every 5 years. I refer to this as the Capital Expenditure Limitation. The frequency and amount will vary from industry to industry and system to system depending on the nature of the business and

the amount of the original capital investment. This will give you information to develop a proper reserve account so that when capital expenditures are required by the franchisor, the money is available to pay for these items.

CHANGES TO MANUAL OR SYSTEM

The typical franchise agreement provides that the manual is a part of the franchise agreement. The franchisor has the right to unilaterally make, without the input or consent of the franchisees, changes to the manual, which the franchisee must comply with within a reasonable period of time. It is like one party to a contract being able to change the terms of the contract without the consent of the other party. This has the effect of allowing the franchisor to change the nature of the relationship without the franchisee's consent. In addition, some of these changes require that you invest in new equipment or other items. Ideally, changes should only occur with the approval of the franchise association. Alternatively, have the franchisor agree to limit changes to the manual to purely operational issues and that no change can alter the terms of the franchise agreement. There should also be a limitation in frequency of change and $ amount. Make sure system changes are implemented on a system-wide basis (after thorough testing) including the franchisor's company outlets and not just on you as the guinea pig.

RENOVATION (REMODELING) OF THE PREMISES

If you operate your franchise outlet out of retail premises where customers come, your franchise agreement may require you to renovate, upgrade or modernize the premises in the future to conform to the franchisor's then current trade dress. Clarify how often you are required to do this (for example, every 5 years or on renewal). Also, put a dollar limitation on the amount of capital expenditures (this usually is not addressed) so you can budget accordingly by establishing reserve accounts to put earnings aside for renovation. Also negotiate a dollar cap on expenditures to conform the system changes.

NEW PROGRAMS

New products and services should be tested by the franchisor and proven successful and profitable before being introduced to the System. Additional costs associated with the new program should be subject to the Capital Expenditure Limitation.

MARKET WITHDRAWAL

Some franchise agreements provide, similar to gasoline companies, that if the franchisor withdraws from a certain market or area, it can terminate the franchise agreement. Try to eliminate this provision or modify it so that you can continue to operate the business under the franchisor's trade name on a reduced license fee without receiving any services.

DEFAULT OBLIGATIONS

If you default under the franchise agreement, there are severe repercussions. In addition to losing your right to operate the franchise business, the franchisor has the right to take over your business including purchasing your business assets for maybe less than their fair value on an ongoing business basis, take over your lease and telephone number and leave you out in the cold. While you have no intention of defaulting – stuff happens! You need to limit the consequences of your default.

DEFAULT BY THE FRANCHISEE

Your events of default normally fall into 3 categories:

1. Events, if they occur, which cause automatic termination of the franchise agreement without notice or right to cure;

2. Events, if they occur, which cause termination of the franchise agreement upon notice by the franchisor but with no right to cure; and

3. Events, if they occur, which cause termination of the franchisee only after written notice from the franchisor and your failing to timely cure.

With respect to (1), make sure "insolvency" is not such an event. Otherwise, the franchisor may be able to terminate your franchise agreement just before you file for bankruptcy relief and you lose flexibility if you are trying to do a Chapter 11 reorganization. There may come the situation where you need to reorganize under Chapter 11, terminate your franchise agreement and not be subject to a post-term covenant not to compete. Bankruptcy may be included but this "*ipso facto*" provision is unenforceable under the U.S. Bankruptcy Code.

With respect to (2), limit the events to truly egregious actions on your part, such as conviction of a felony, willful breach of confidentiality by you (not some low-level employee) or non-compete covenants, etc.

With respect to (3), make sure the events are reasonable and that you have at least 10 days to cure a monetary default and at least 30 days, after written notice from the franchisor specifically describing the nature of the default to cure a non-monetary default. Certain events of default of a monetary nature such as the entry of a judgment against the franchisee, the execution and levy of the franchisee's business assets and the like should have some materiality threshold such as involving $10,000 or more before it is considered a material default.

MONETARY DEFAULT

The franchise agreement will provide that if you fail to pay any sums due the franchisor the franchisor has the right to terminate the agreement. Sometimes the franchise agreement provides that termination can occur due to monetary default without written notice or opportunity to cure. Since a service fee, late charge and interest may be provided for late payments, require that you be given written notice of the default and an opportunity to cure at least 10 days but 30 days is better.

CURE PERIOD

If you default under the franchise agreement you should, in most cases, be given written notice by the franchisor setting forth the precise nature of the default and what you must do or not do to cure the default. You should be given a reasonable period of time in which to do this. Typically, the period should be 30 days and, if the breach cannot reasonably be cured within 30 days, a longer period of time provided you undertake and continue efforts to cure the breach until completion.

INSOLVENCY

During the course of operating many small business there may come a time due to poor cash flow that you become technically "insolvent," that is, your business liabilities exceed your business assets and you are unable to pay all of your bills as they become due. It is entirely different than when you file an insolvency proceeding. You just have to work your way out of the problem.

The typical franchise agreement provides that if the franchisee becomes insolvent, this constitutes an automatic, non-curable event of default and your franchise agreement is terminated. If the agreement is terminated before you are able to seek some sort of bankruptcy protection, the franchise agreement is not considered to be part of your bankruptcy estate and you may lose flexibility in being able to accept or reject the franchise agreement as an executory contract.

Therefore, ask that the language "shall become insolvent" be changed to "shall be judicially declared insolvent." There may exist the situation where you desire to reorganize under Chapter 11, terminate your franchise agreement and may not be subject to a post-term covenant not to compete.

CRIMINAL CONVICTION

There may be a default provision stating that if you or one of your partners or employees is convicted of a crime this constitutes a non-curable event of default and you lose your franchise. You should have the provision changed to apply to felonies and not misdemeanors and also be given the right to sever the person's relationship to the franchisee to cure default unless the criminal activity occurred at or related to the operation of the Franchised Business.

YOUR DEATH, DISABILITY OR INCOMPETENCY

What happens to your business if you die, or become disabled or incompetent while a franchisee? Do you have a reasonable time to transfer the business to your family or sell the business? The franchisee should have up to 12 months to transfer upon death or incapacity. Is there an insurance policy between you and the franchisor (sort of like "key-man" insurance) whereby the franchisor is the beneficiary and is obligated to buy your franchise with the insurance proceeds? This needs to be addressed.

DEFAULT OF MINIMUM PERFORMANCE STANDARD

Some franchise agreements, particularly where an exclusive territory is granted, provide that the franchisee must meet some minimum level of performance; otherwise the franchisee loses his or her exclusivity or worse, loses the franchise agreement. You should first determine whether the minimum performance standard is reasonable. It should separate the "Cs" from the "Fs" and not the "As" from the Bs." It should also be revised to reduce the penalty to loss of exclusivity rather than termination of the franchise agreement or perhaps, some monetary payment to the franchisor.

DEFAULT BY PRINCIPAL

If a principal of a corporate franchisee defaults, the franchisee should have the right to cure by severing that person's relationship with the franchisee.

REPEATED CURED DEFAULTS (3 STRIKES AND YOU'RE OUT)

Sometimes there is a default provision in the franchise agreement that provides that the franchisor can terminate the franchise agreement if the franchisee defaults 2, 3 or more times in any 12-month period, even if each default is timely and properly cured. While a franchisor may not want to continue to deal with a recalcitrant franchisee – a cure is a cure. The franchisor's remedy should be reimbursement of any costs it sustains due to the franchisee's default, the "nuclear bomb" of termination should not be available.

CROSS DEFAULT

A cross default provision means that default under one agreement is automatically a default under another agreement even if it doesn't specifically constitute default under the other agreement. For example, the franchise agreement may provide that default under the lease constitutes default under the franchise agreement. If you operate more than one unit (a "multi-unit franchisee") the franchise agreements may provide that a default under one agreement constitutes a default under all other agreements. This could have a "domino effect" causing all agreements to be terminated. Try to have such a provision eliminated, as each agreement should stand on its own.

POST-TERMINATION/EXPIRATION OBLIGATIONS

Upon the expiration or termination of the franchise agreement, you may have a number of obligations to the franchisor, including:

1. The franchisor may have the option (not just a right of first refusal) to purchase your franchise business. If so, make sure it is at fair market value rather than book value so you get a higher and fairer price.

2. The option to purchase may be limited to items bearing the franchisor's proprietary marks, such as inventory, paper goods, equipment, signage, etc. Require the franchisor to purchase these items since you probably can't resell or use them, whereas the franchisor is the only one who can sell or reuse them. Make sure that the purchase price is cost or fair market value,, whichever is greater.

3. If you sublease the premises from the franchisor, the sublease may provide that the expiration or termination of the franchise agreement constitutes a default under the lease. Even if you lease from an unrelated third party, your franchise agreement may require you and your landlord to agree to allow the franchisor to take over the lease and the premises if you default under the franchise agreement. You then can be evicted from the premises. Try to negotiate that you can stay and operate a dissimilar business under a different name if you desire.

4. If you stay at the premises, the franchise agreement will likely require you to "de-identify" the premises, that is, make changes in signage, color, layout, etc. so that the public doesn't know it was once part of a franchise chain. Know, before signing the franchise agreement, what the franchisor expects of you in this regard and the likely cost.

5. You may be required to sign a telephone power of attorney that allows the franchisor to control the telephone number and listing. You will have to get a new number. You may not have the new number in the telephone book for several months. If you remain at the premises, try to retain the right to the same telephone number.

Many of these post-termination obligations are penal in nature. Maybe they are appropriate if you default. Are they appropriate if you decide not to renew and want to operate independently? They certainly do not appear to be appropriate if you terminate the franchise agreement due to the franchisor's default! Try to negotiate that these provisions only apply on termination due to your default.

CEASE OPERATIONS

Many franchise agreements provide that, upon the expiration or termination of the franchise agreement for any reason whatsoever (even if the franchise agreement is terminated due to the franchisor's default!), you agree to cease operating the business. This should be limited to default by the franchisee and should not apply if the franchise agreement expires and you do not renew or if you terminate the franchise agreement due to the franchisor's default. In these circumstances you should be able to operate independently at the same location as long as you de-identify.

FRANCHISOR'S OPTION TO PURCHASE THE FRANCHISEE'S BUSINESS

The franchise agreement usually provides that the franchisor has the option to purchase the franchisee's business on some set formula upon the expiration or termination of the franchise agreement (even if the franchise agreement is terminated due to the franchisor's default!). In some franchise agreements this option exists at any time during the term. This may not be in your best interest since the only time the franchisor would be interested in buying your franchise is if it is very successful.

This option should be limited to termination of the franchise agreement due to your default and not at any time, or upon termination of the franchise agreement due to the franchisor's default or upon the expiration and nonrenewal of the franchise agreement. The purchase price should be based on the business's fair market value on an ongoing business basis and not upon some other formula that gives the franchisor a windfall. You should receive all cash and not take a note. If you do take a note, make sure it is secured by a purchase money security interest in the assets sold so that, if the note is not paid, you can go back in and take over the business.

FRANCHISOR'S OPTION TO PURCHASE CERTAIN ASSETS

Upon expiration or termination of the franchise agreement (regardless of the cause), a franchisee is precluded from using the franchisor's proprietary marks including items bearing the proprietary marks such as signage, paper goods, etc. These items may still have value, but the only person who can use them is the franchisor and perhaps other franchisees. Many franchise agreements give the franchisor, upon expiration or termination of the franchise agreement, the option, but not the obligation, to purchase these assets, usually at cost or fair market value whichever is less. This provision should be changed to a "put," meaning that the franchisor must buy back these items from you since you cannot continue to use them. The purchase price should be fair market value.

TELEPHONE NUMBER

Many franchise agreements provide that, upon the expiration or termination of the franchise agreement for any reason (even if the franchise agreement is terminated due to the

franchisor's default!), the franchisor has the right to take over your telephone numbers. This has the effect of diverting your business. This provision should be limited to termination of the franchise agreement due to the default by the franchisee and should not apply if the franchise agreement expires and you do not renew or if you terminate the franchise agreement due to the franchisor's default. In these circumstances you should be able to go independent and keep the telephone number but change the name in the next printing of the listings to eliminate the franchisor's trade name.

ASSIGNMENT OF LEASE UPON DEFAULT

Many franchise agreements provide that upon the expiration or termination of the franchise agreement for any reason whatsoever (even if the franchise agreement is terminated due to the franchisor's default!), the franchisor has the right to take over the lease and your business premises. You need to have this provision limited to termination of the franchise agreement due to default by you and not to termination of the franchise agreement due to the franchisor's default or expiration and non-renewal of the franchise agreement. In these circumstances you should be able to go independent at the same location as long as you de-identify. In any event, provide that if the franchisor takes over your lease, that the landlord releases you from all future obligations under the lease. Otherwise, you continue to be liable.

COVENANTS NOT TO COMPETE

A covenant not to compete is a promise by you to the franchisor that you will not operate a business similar (competitive) to the franchise business. The covenant applies while you are a franchisee (that is, "in-term") and for a period of time (usually 2 years) after the franchise agreement expires or is terminated (that is, "post-term"). If you already have, or are contemplating to have, a competing business while you are a franchisee or you are, or plan to be, a multi-concept franchisee, carve out these businesses as exceptions to the covenant. If you are already in a similar business (for example, you are a conversion franchisee), negotiate to eliminate the post-term covenant.

With respect to the post-term covenant, try to provide that it does not apply if: the franchise agreement expires and is not renewed; the franchise agreement is transferred to a franchisor-approved buyer (but your buyer may want one); or the franchise agreement terminates due to default by the franchisor. One state, California, refuses to enforce any post-term covenant not to compete.

COVENANT NOT TO SOLICIT

Many franchise agreements provide that during the term and for a period of time thereafter you agree not to solicit the employees of fellow franchisees or of the franchisor. As long as similar covenants apply to your fellow franchisees and the franchisor so that your employees cannot be raised, it is not an unreasonable provision.

INDEPENDENT COVENANTS

In contract law, covenants, promises or agreements made by one party are usually dependent upon the other party honoring its covenants, promises or agreements. If one party fails to honor its covenants, promises or agreements, the other party is excused from its obligations to perform under the agreement. The covenants are considered "dependent." However, if the contract specifically provides that a covenant, promise or agreement is independent of the other

party's performance, and can be enforced even if the other party is in default under the contract the promise is considered to be an "independent" covenant.

The typical franchisor-oriented agreement does not contain any independent covenants of the franchisor. However, it usually specifically provides that the franchisee's covenants not to compete are independent covenants by providing that the franchisor can enforce the covenant not to compete against you and put you out of business for 2 years, even if the franchisor is in default under the franchise agreement. I have witnessed a court so ruling. While the franchisee may still have an action for damages for breach of contract, a lawsuit to obtain a judgment against the franchisor will take years and thousands of dollars - all during a period when you cannot operate your business. How can you afford any justice?

FUTURE ROYALTIES (LOST PROFITS)

A franchise agreement is a long-term contract, usually 10 years. The franchisor expects to be receiving royalties from you over this entire period. If you default and the franchise agreement is terminated, you may become liable for all future royalties from the date of termination to the date of expiration, which could several years and hundreds of thousands of dollars. To avoid having to prove the amount of lost profits, there may be a liquidated damages provision providing that upon termination due to your breach, you agree to pay the franchisor liquidated damages of some fixed or ascertainable amount such as 3 years royalties.

While the entitlement to lost profits by a franchisor varies from state to state based on state laws and court decisions, you should change the franchise agreement to include a cap or reasonable liquidated damages provision relating to the franchisor's lost profits due to your default. Future royalties are not pure profit for a franchisor. There are numerous costs associated with the franchisor's ongoing service and support of its franchisees that must be taken into account. Further, a present value discount of money should be factored in.

DEFAULT BY THE FRANCHISOR

I find it amusing that many franchise agreements do not even address the possibility of default (breach of the franchise agreement) by the franchisor, while the franchise agreement sets forth innumerable ways in which you can default. I call the franchisee default provisions the "50 ways to leave your lover" provisions.

There should be a provision relating to the franchisor's default and your rights if this happens. It certainly is not unreasonable to request to have a provision that requires the franchisor a 30-day grace period after written notice to cure a default. Also, try to provide that, if the franchisor fails to cure a default, you have the option to terminate the franchise agreement and, in addition to a claim for damages, you are not subject to any post term covenant not to compete, so that you can continue to operate the business under a different trade name without further payments or other obligations to the franchisor.

DISPUTE RESOLUTION MECHANISMS

Due to the tremendous time and cost for all parties involved in going to court, many franchise systems are implementing alternative dispute resolution mechanisms, such as mediation and arbitration. However, the franchisor puts provisions in the franchise agreement that severely limit your rights such as a right to jury trial, right to punitive damages, shortened statutes of limitation and

right to try the dispute where you are located. The provisions can become significant hurdles for you to overcome in seeking justice.

MEDIATION

Mediation involves the parties and their counsel meeting with a qualified third party neutral who assists the parties in trying to settle a dispute in a business manner that resolves the dispute and maintains the working relationship between the disputing parties. If the parties are unable to resolve the dispute through mediation the parties can then arbitrate or, litigate the dispute. Mediation is the cheapest, lowest risk, and most under-utilized form of alternative dispute resolution. Mediation makes sense when the parties can't seem to resolve the dispute themselves. However, it will only be effective if both parties are willing to mediate in good faith and are prepared to compromise. There are now private, independent organizations, other than the American Arbitration Association, who specialize in providing these services to franchisors and franchisees, such as the Center for Public Resources - National Franchise Mediation Program, Endispute and Franchise Dispute Resolution Service.

ARBITRATION

Arbitration is the non-judicial resolution of a dispute made by 1 or 3 individuals called arbitrators. The arbitrators serve as judge and jury. The trial is less formal and the rules of evidence are liberally construed and pre-trial discovery is limited. The arbitrator's decision is usually final and binding on the parties and not appealable. There are now private, independent organizations, other than the American Arbitration Association, who specialize in providing these services to franchisors and franchisees, such as the Center for Public Resources - National Franchise Mediation Program, Endispute and Franchise Dispute Resolution Service.

If your franchise agreement provides for arbitration of disputes, make sure that arbitration takes place in your county (rather than at the franchisor's home office); that one of these specialized organizations is used; and perhaps, that the non-prevailing (losing) party pays the attorneys' fees and costs of the prevailing (winning) party.

However, arbitration is not perfect. In my experience, arbitration is not cheaper, faster or better. In fact, these are many times where a franchisee would be better off having the issue decided by a jury of his or her peers. Nearly all franchise agreements provide that arbitration is on a single franchisee basis. Therefore, in any event, if you are satisfied with arbitration, you should have the right to have group or class action arbitration. Discuss these issues with your attorney.

ATTORNEYS' FEES

Discuss this issue with your attorney. There are good reasons pro and con about an attorney's fee provisions. If an attorney's fee provision exists, make sure the attorney's fees applies to the prevailing (winning) party, whether franchisor or franchisee, and is not just for the benefit of the franchisor. Otherwise, in the event of a dispute, you may have to pay your own attorney's fees, even if you win.

GOVERNING LAW

The parties to a contract can agree that the laws of a particular state will govern the parties and the contract. The courts have ruled that the state selected by the parties must have some "reasonable

relationship" to the parties, such as where one of the parties resides or has its principal office. Most franchise agreements provide that the law of the state where the franchisor's headquarters is located will govern. If you live in a state having no franchise laws and the franchisor is headquartered in a state having franchise laws, then this provision is probably satisfactory provided the franchise agreement does not specifically exclude these franchise laws or if these franchise laws do not apply to out-of state franchises or resident of other states. If you live in a state having franchise laws and the franchisor is living in a state having no franchise laws, then it probably is better to have your state's laws govern. However, this provision is hard to renegotiate because of the franchisor's desire for uniformity of the laws applying to its many franchise relationships.

LOCATION OF ARBITRATION OR MEDIATION (VENUE)

Venue is the place where the parties agree to resolve disputes, whether by mediation, arbitration or litigation. Generally, the franchise agreement provides that venue will be in the county where the franchisor's headquarters is located and not the county where your business is located. This may be hundreds or thousands of miles away from you, which will make it more costly and difficult for you to prosecute or defend a claim. One of the reasons franchisors do this is to make it harder for you to sue or defend. You, your lawyer and your witnesses may be thousands of miles away. While there are a few states that will not enforce these provisions (for example, California, Connecticut, Illinois, Massachusetts and Michigan), most states will. Try to change the jurisdiction and venue provisions to the state where you are located if the dispute is just between you and the franchisor or where the franchisor is located if a group or class action.

LIMITATIONS OF CLAIMS (STATUTE OF LIMITATIONS)

Under the law, to prevent old and stale claims from being litigated, a claim must be asserted within a certain period of time, usually 1 to 5 years, depending on the nature of the claim. Otherwise, the claim is barred from being raised and a lawsuit can be dismissed if filed. These laws are called "statutes of limitations." There may be a provision in the franchise agreement shortening the time you can bring a claim against the franchisor and vice-versa. This provision hurts you more than the franchisor because you may not know you have a claim against the franchisor until you have a problem and consult a franchise attorney. The franchisor's claim is usually for unpaid royalties of which the franchisor is immediately aware. This provision only favors the Franchisor in that it knows when you do not pay. On the other hand your claims relate to fraud, breach of contract, etc. that have longer statutes of limitations under state law.

WAIVER OF PUNITIVE (EXEMPLARY) DAMAGES

Punitive (exemplary) damages are special damages awarded by a court of jury as additional punishment beyond actual damages sustained by the other for a serious wrong. Generally, the claim has to be in the nature of a tort claim rather than a breach of contract claim unless a statute provides otherwise. In franchising, the vast majority of punitive damages awards have been in favor of franchisees against franchisors. That is why the franchisor wants to eliminate it. Some franchise agreements now limit the ability of the parties to sue each other for punitive damages. Since most punitive damage awards are against the franchisor and in favor of the franchisee, no wonder this provision is cropping up in franchise agreements. You should not waive your right to obtain punitive damages against the franchisor if its actions warrant.

WAIVER OF TRIAL BY JURY

While you have the constitutional right to a jury trial for certain crimes, there is no constitutional right to a jury trial for a civil matter such as breach of contract. Many modern contracts, including franchise agreements, contain a waiver of trial by jury provision whereby you waive the right to have a jury of your peers decide issues of fact and the judge will decide. Agreeing to binding arbitration has a similar effect since issues of fact will be decided by the arbitrator. Years ago, an old-time Florida attorney told me "the only thing I allow my clients to waive is the American Flag." This is good advice.

INJUNCTIVE RELIEF

To prevent harm, which cannot be undone and for which monetary damages are inadequate ("irreparable harm"), a person may want a court to issue an injunction enjoining a person from doing something ("injunctive relief"). Even if mediation and/or arbitration is required, the franchise agreement will typically provide that the franchisor can go to court to obtain injunctive relief against the franchisee for alleged trademark infringement, unfair competition and other matters. There may be circumstances where the franchisee may want to enjoin the franchisor, such as enjoining it from terminating the franchise agreement when the grounds for termination are in dispute. Therefore, this provision usually has to be revised, so that you have these remedies as well.

SPECIFIC PERFORMANCE

Specific performance is the right to obtain a court order ordering a party to specifically do something under a contract. In many franchise agreements this right is reserved solely by the franchisor. This provision should be made mutual. You should have this remedy as well.

GOOD FAITH AND FAIR DEALING

Many franchisee victories in court have been on the legal theory that the franchisor breached the implied covenant of good faith and fair dealing that caused damage to the franchisee such as encroachment and cannibalization. This argument is limited to the instances where the terms of the franchise agreement were ambiguous or where the franchisor reserved discretion and exercised this discretion in an unreasonable manner. It is best to have a specific provision in the franchise agreement requiring both parties to act in good faith and deal fairly with each other.

RELEASE OF PRIOR CLAIMS

Many franchise agreements, usually at the end of the agreement in the "Miscellaneous" or "General Provisions" contain a "Release of Prior Claims" provision whereby, on your signing the franchise agreement, you release the franchisor from any prior claims you may have against the franchisor including the franchisor's violation of the franchise laws. In some states this provision is unenforceable. It is best to delete this provision.

ENTIRE AGREEMENT

Most franchise agreements have a provision near the end of the franchise agreement, usually in the "Miscellaneous" or "General" article, which provides that the franchise agreement represents the entire agreement between the franchisor and the franchisee. This is legally referred to as an

"integration" or "merger" provision. Any oral representations, promises or understandings by the franchisor or its representatives including franchise brokers (such as unauthorized earnings claims) which are not specifically included, in writing, in the franchise agreement or in an addendum to franchise agreement may not be enforceable or binding on the franchise agreement. You can only rely on what is in the franchise agreement and not any oral representations. This is why everything told to you and upon which you are basing your investment decision must be put in an Addendum to Franchise Agreement. This is why it is critical that any promises by the franchisor or its agents that are important to you and are reasons why you have decided to purchase the franchise must be included in the franchise agreement or the addendum. Make sure everything is in "black and white."

REMEDIES

Usually there is another "boilerplate" provision in the franchise agreement whereby the franchisor's remedies for the franchisee's default are cumulative. Make this provision mutual in that the franchisee's remedies for the franchisor's default are cumulative as well.

WAIVER

A "boilerplate" provision in a franchise agreement is the anti-waiver clause. It usually provides that a waiver of a provision by the franchisor against the franchisee, such as a waiver of default, does not constitute a waiver of the right to demand strict performance in the future. This is not an unfair provision. However, this should be made mutual so that a waiver by the franchisee of any rights it has against the franchisor under the franchise agreement does not prevent later enforcement of the provision by the franchisee.

MISCELLANEOUS

There are a number of other provisions that may be contained in the franchise agreement that need your attention. The issues are listed in alphabetical order.

ANTI-DISCRIMINATION AMONG FRANCHISEES

I have known of situations where similarly situated franchisees were treated differently by the franchisor in substantially similar circumstances because the franchisor favored one franchisee over the other. Perhaps one franchisee is active in forming a franchisee association and the other "doesn't rock the boat." Several states have laws that prohibit a franchisor from discriminating unfairly among franchisees. Since the odds are that you do not live in one of these states, you should request this provision be included to prevent the franchisor from unfairly discriminating among franchisees including you.

APPROVAL OR CONSENT BY THE FRANCHISOR

There will be several provisions in the franchise agreement where the franchisor's consent or approval is required and the franchisor reserves the right to say yes or no - in its sole and absolute discretion. This puts you solely at the mercy of the franchisor. It is best to provide that "whenever the approval or consent of the franchisor is required under the franchise agreement such consent or approval will not be unreasonable withheld, delayed or conditioned (more than 30 days)."

FAIL TRAINING

You are required to successfully complete the franchisor's initial training program before you can open the franchise. What if you fail? While it may as rare an event as failing an army physical, it may happen. You should have the franchise agreement provide that if you fail to successfully complete training is you get all your money back except the franchisor's reasonable expenses. If the post term covenants continue to apply in this event, they should be limited to the confidentiality and noncompete provisions and not prohibit you from operating a competitive business.

FORCE MAJEURE

A force majeure provision usually provides that a party to a contract is excused from performance where he or she is unable to perform due to an act beyond the control of the party such as earthquakes, floods, hurricanes, tornadoes, and other act of God. If a force majeure provision does not appear in the franchise agreement suggest that this language be added to protect the interests of both parties. If the provision is solely in favor of the franchisor, insist that it be made mutual so you also get the benefit of it. Who knows when a fire, flood, earthquake, hurricane, riot, bombing, etc. will occur?

FRANCHISOR'S OBLIGATIONS

If a party agrees in a contract that it "may" do something, if the party fails to do it, the failure does not constitute a breach of the agreement. If a party agrees in a contract that it "will" or "shall" do something, if a party fails to do it, the failure constitutes a breach of contract. What are you getting for your franchise fee and royalty checks? Note how many of the franchisor's obligations to you are "illusory" because of the word "may" instead of "will." Things you expect the franchisor to do for you must include the words "will' or "shall."

FULL TIME EFFORTS

Most franchise agreements provide that the franchisee must use his or her full time efforts in operating the franchised business. Since most royalties are based on gross revenues, the franchisor wants you to work as much and hard as possible to maximize revenues. If operating the franchise business will not be your full-time occupation, you need to change this provision. You need to have the right to have a manager and other employees operate the business under your supervision.

INDEPENDENT CONTRACTOR

One of the benefits of franchising for both the franchisor and the franchisee is that the franchisee is not an employee of the franchisor but operates its own business under a common name and system as an independent contractor. In additional, generally a franchisor is not liable for the actions of its franchisees and of the franchisee's employees (no "vicarious liability"). There will be a provision or provisions in the franchise agreement providing that the franchisee is not the agent, employee, partner or joint venturer of the franchisor but is an independent contractor. This is beneficial for both parties. However, make sure it also provides that that the franchisor is not an agent of the franchisee, as well.

INSURANCE BY THE FRANCHISOR

Also have your insurance determine what insurance, if any, the franchisor should maintain for its benefit ands the benefit of all of its franchisees. If the franchisor or an affiliate sells you products or services, make sure that the seller maintain adequate product liability or errors and omission insurance which includes the franchisees as additional insureds (see **PRODUCT LIABILITY INSURANCE** below).

MAXIMUM PRICE LIMITATIONS

For over the past 30 years until recently, it was the law of the land that price fixing was a violation of the antitrust laws. It was considered to be "*per se* illegal" in that you did have to prove damages. All franchise agreements contained provisions making it clear that, while the franchisor may suggest prices (for example, "M.S.R.P."), the franchisee was free to set its own prices. Many franchise agreements still do contain this provision, including the ones I draft. However, the law was cut back with the U. S. Supreme Court holding the an agreement to set the maximum retail price between an oil company and dealer was not *per se* illegal but subject to the "Rule of Reason." It is best from the franchisee's standpoint to have no such restrictions. That is why on commercials you'll see at the end a disclosure such as "at participating dealers only" or "prices may vary." If the franchise agreement dictates prices, it is probably illegal and the drafter did not know the law. The franchisor's setting of the maximum retail prices charged by its franchisees will squeeze the franchisees' profit margins while the franchisor continues to collect money off the top.

NAME, HOME ADDRESS AND TELEPHONE NUMBER

Under the states Guidelines, a franchisor is required to include the name, home address and telephone number of all franchisees who left the system within the previous fiscal year or who have not communicated with the franchisor within the 10-week period before the effective date of the FDD. The franchise agreement may address these issues and require you to agree to it. Once you become a franchisee and for over a year after you cease to be a franchisee, you can expect phone calls.

OBLIGATIONS OF THE FRANCHISEE

Understand fully your obligations under the franchise agreement and any other agreement you are required to sign, such as a sublease, guarantee, software license agreement, telephone power of attorney, etc. Know what is required of you before your unit opens, after your unit opens, and after the franchise agreement expires or terminates. A table briefly describing your obligations is set forth in ITEM 9 of the FDD. Read the specific provisions of the franchise agreement very carefully to fully understand your obligations.

OBLIGATIONS OF THE FRANCHISOR

There will be one or more sections of the franchise agreement that set forth what the franchisor will do for you. Be careful to note whether the franchisor "shall" or "will" do something versus "may" do, or "intends" to do, something. If the franchisor "shall" or "will," the franchisor must perform the obligation, otherwise it is a default under the franchise agreement. If the franchisor "may" do something, the franchisor's obligation is discretionary and if the franchisor does not perform the obligation, you probably cannot legally complain. Surprisingly, many franchise agreements provide few ongoing services that the franchisor is legally required to provide to you. I call these provisions the "Jell-O" provisions because when you are looking to see if the franchisor is in breach of its obligations to you under the franchise agreement, such as the lack of meaningful service and support, you really

can't get a handle on them. ITEM 11 of the FDD sets forth in tabular form a description of the franchisor's contractual obligations to you.

OTHER BUSINESS ACTIVITIES

Some franchise agreements provide that you must devote your full-time efforts to operating the business. Are you involved in any other business activities that may conflict with this provision? (See **COVENANT NOT TO COMPETE** above.)

SPECIAL LICENSES OR PERMITS

Some businesses require a special license or permit in additional to a general business license. For example, if you buy a real estate franchise, you or your manager must have a real estate brokerage license. This requirement should be disclosed in ITEM 1 of the FDD under "Special Industry Regulations." You need to determine if you need any special licenses or permits, what it will cost and how long it will take to obtain.

TAXES AND LIENS

Most franchise agreements require that you agree to pay all taxes and not allow any liens to be placed on your business assets. This is not unreasonable. However, if not already provided in the provision, add the right of the franchisee to contest the taxes and other obligations in good faith.

TIME OF ESSENCE

A time of the essence provision makes all time periods in the franchise agreement practically fixed in stone. These time periods are usually imposed more on the franchisee than on the franchisor. If you do not satisfy these time periods you may be in material default under the franchise agreement. Try to eliminate this provision.

CONCLUSION

If you are successful in getting any renegotiation of the franchise agreement, the renegotiated terms should be reflected in an Addendum to Franchise Agreement. Remember that you cannot sign the franchise agreement until 7 days after the renegotiated provisions are provided to you.

If you are not successful in getting any or all that you want, please take heart as today, this is still the rule rather than the exception, but it may not be tomorrow. If you are not able to obtain what you feel you really want or need, perhaps you should pass on this opportunity and look at another franchise offering such as one that has received the AAFD Fair Franchising Seal.

Keith J. Kanouse