

Franchise & Distribution Law Letter

Spring 2007

QUESTIONS YOU NEED TO ASK WHEN REVIEWING FRANCHISE AGREEMENTS

With the FTC Franchise Rule Amended, you probably have reviewed your FOC concerning (a) franchisee relocations and additional outlets, (b) your plans to operate a competing similar system, (c) warnings where the franchisee buys a non-exclusive territory, (d) wording of confidentiality clauses, (e) franchisor-sponsored, endorsed or created franchisee associations, and (f) territorial protection disclosures related to the internet, catalogs and telemarketing.

Now, it's time to turn your attention to your Franchise Agreement. Is your Franchise Agreement up-to-date? Do you need an expert review?

Here are some important questions to consider regarding the following topics:

1. Length of Term and Renewals
2. Territories and Expansion
3. Site Selection and Financing
4. Franchise Fees and Royalties
5. Auditing
6. Software and Required Products (Designated Suppliers)
7. Protecting Your Trademarks, Copyrights, Trade Secrets and Internet Site
8. Choice of Law
9. Choice of Place of Litigation (Forum)
10. Transfers
11. Termination
12. Mediation
13. Arbitration
14. Non-Competes and Defenses to Them
15. Antitrust
16. Negotiated Agreements



SHIPMAN & GOODWIN LLP

COUNSELORS AT LAW

As a Franchisor, your Franchise Agreement is the crucial document in your relationship with your franchisees. It sets forth their obligations and yours, as well as their rights and yours. It protects your trademarks, copyrights, and trade secrets. It defines the grounds for site selection, transfers, terminations, and renewals. It establishes the franchise fees, royalties, advertising system and advertising fees. It states what state law governs your system, where you and franchisees can litigate, and whether you or they must mediate or arbitrate disputes. And it protects the System by requiring ex-franchisees to refrain from competing for a time after leaving the franchise family.

Thousands of cases are decided each year that affect franchise systems. As a wise Franchisor, you should re-evaluate your Franchise Agreement each year, to determine if it is up-to-date, meets the needs of your changing (and growing) System, and remains lawful in all respects, in our ever-changing legal environment.

The Partners and Associates in the Franchise and Distribution Practice Group at Shipman & Goodwin have a total of over seventy years of experience, and include leaders in the American Bar Association and Connecticut Bar Association Franchise and Distribution sections. Their services include counseling, preparing necessary documents and litigating on behalf of large, medium-sized, and new franchisors.

Below in detail are some of the most important subjects to consider in your Franchise Agreement review:

1. **Length of Term and Renewals**

Most Franchise Agreements have initial terms of ten to twenty years. Does the term you chose still make sense for your System, in light of the investments you and franchisees make in the franchises, and the desirability of retaining flexibility for appointment of new franchisees? How many renewal periods should be granted? What should be the requirements for a franchisee to obtain renewal? To what degree can you rely on requiring the franchisee to sign the “then current” form? There are many state laws that bear on this. For example, Connecticut’s Franchise Act regulates renewals, among other subjects.

2. **Territories: Exclusivity and Expansion**

Should franchisees continue to have exclusive territories or geographic areas in which you will appoint no other franchisee? How best can you reserve the right to do business through your company-owned locations if you desire? What about competing with franchisees using different trademarks? How can you ensure that you will avoid expensive “encroachment” claims by franchisees? Should franchisees have the right to expand their territories? Should they have rights of first refusal to expand? What requirements should they have to meet to expand, both in performance and financial resources?

3. **Site Selection and Financing**

You must approve the franchisee's location, but how much assistance should you provide? Should you promise to provide it, or does such a contractual "requirement" invite a franchisee to claim its failure was due to your poor advice? Should you offer to find or to supply financing? Or is such a commitment a more of a legal risk to you than it is worth as a benefit to franchisees?

4. **Franchise Fees and Royalties**

Does your initial franchise fee make sense? (Is it now too low, for example?) What about your royalty's structure? Are you collecting royalties on a monthly basis, and is that the wisest interval? What is your charge for late payments, and is it lawful? Do you have required electronic fund transfers for franchisees?

5. **Auditing the Books**

Do you have the right to periodically audit the franchisee's books? Can you access them by computer? At what point is the audit cost transferred to a franchisee who has underreported and/or underpaid?

6. **Software and Required Products;**

Designated Suppliers

To what extent do you require franchisees to obtain software and other products from you or from designated suppliers? To what degree do you evaluate and stand behind your designated suppliers? How free are franchisees to propose and use other suppliers? In light of the Supreme Court's decision in *Image Technical Services, Inc. v. Eastman Kodak Co.*, are you providing

franchisees with enough up-front information to avoid possibly ruinous tying arrangement claims by alleged uninformed and "locked-in" franchisees?

7. **Trademarks, Copyrights, Trade Secrets and the Internet**

Are your trademarks and servicemarks federally registered? Does that include your slogans and logos that may be registrable? If you have training materials and other publications, have you filed them for copyright protection? Are the trade secret and confidential information provisions in your Franchise Agreement specific enough, and are you fulfilling your obligations under the applicable state trade secret statutes to actually **protect** your System's secrets? Is your internet site useful and sufficient to protect the System? To what extent can – and should – you prevent or regulate franchisee sites?

8. **Choice of Law**

Does your Agreement have an enforceable **mandatory** choice of law provision? Would a court enforce the choice in light of the legal principles governing choice of law, such as the extent of the parties' contacts with the chosen state, and the "public policy" of states which may have different rules favoring their local franchisees? What can you do to protect the System and achieve uniformity in legal decisions?

9. **Choice of Forum**

Does your Agreement have an enforceable **mandatory** "choice of forum" provision, i.e., a clause that recites **where** court action **must** be

filed? Did you know that the law on this subject is different in various states, and at least one state will not enforce these clauses under certain circumstances? Do you know the requirements for a successful choice of forum clause? Have you considered the benefits and the possible disadvantages?

10. **Transfers**

What requirements do you impose on proposed franchise transfers? Are the requirements sufficient to protect your System against the introduction of unqualified, financially insecure franchisees, or franchisees who will not devote their full time to your System? On the other hand, are the transfer requirements overly burdensome? Did you know some states have special franchise-oriented statutes in this area?

11. **Termination**

What grounds do you reserve to terminate the Franchise Agreement? Do you provide franchisees the right to cure breaches, and, if so, how many such rights, and concerning which breaches? Are the termination grounds sufficient in number, without being heavy-handed? Are you aware that many states have special termination statutes protecting their local franchisees, and that regardless of your “choice of law” clause, you often have to abide by the notice and limited good cause specifications of those state statutes?

12. **Mediation**

Does your Agreement require mediation

(attempted settlement before a “mediator”) of disputes before the parties litigate? If so, does it carve out the right to seek court injunctions to prevent immediate “irreparable” harm, regardless of a mediation requirement?

13. **Arbitration**

Have you considered the advantages and disadvantages of requiring arbitration of disputes, i.e., resolution of disputes out of court, in a less formal “trial” before an arbitrator chosen by the parties. For example, have you evaluated the issues of expense, speed, breadth of “discovery”, and limited appealability in making this decision?

14. **Non-Competes and Defenses to Them**

Do you have an **enforceable** post-termination (and post-expiration) franchisee non-competition obligation? Do you know that the states vary widely in standards, and that one even bans these requirements by statute? Did you know that your non-compete clause may have to meet the standards of both the “choice of law” clause of your Franchise Agreement and **also** of the state where the ex-franchisee operates? Does your Franchise Agreement have a “savings clause” or “severability clause” so the non-compete can be partially enforced if its scope (duration or geographic area) is ruled overbroad? Does your Franchise Agreement prevent a franchisee from defeating the non-compete by demonstrating that your failure to fulfill obligations to the franchisee prevents you from enforcing your non-compete? Do you know when to litigate your non-compete rights, and when to settle?

15. Antitrust

Are you aware of the impact of the United States Supreme Court's rulings on territorial and customer resale restrictions, tying arrangements and resale price maintenance on your System? Are you anticipating the affect of the Supreme Court's decision this Spring, which could end the rule of automatic ("per se") illegality for all resale price maintenance and have a decisive positive impact on a franchisor's right to prevent discounting by franchisees?

Shipman & Goodwin is well qualified to counsel franchisors in all areas of franchising, from registration and disclosure, to Franchise Agreements, to ongoing advice, to mediation, arbitration, and litigation. We welcome the opportunity to work with you. ▲

16. Negotiated Agreements

Will you negotiate modifications of your standard Franchise Agreement? Did you know that, with the exception of certain states with franchise "anti-discrimination" statutes, you are free to enter into different agreements with different franchisees, provided that you disclose this in your Offering Circular?



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