The Franchise Relationship: Trends in the Law

A Roundtable Discussion

Photography: Carmen Natale

Is it a franchise or a license? We've invited six noted practitioners to help answer this and other questions about the laws governing the franchise business relationship. They are Robert C. Brady, an associate with Gibbons in Newark; Michael Einbinder, partner in Einbinder & Dunn in New York; Lane Fisher, partner in FisherZucker in Philadelphia; Benjamin A. Levin, partner in Ballard Spahr Andrews & Ingersoll in Voorhees, NJ; Adam J. Siegelheim, shareholder in Stark & Stark in Princeton; and Craig Tractenberg, partner in Nixon Peabody in Philadelphia and New York. This discussion was edited by freelance reporter Anne Dorfman and reported by Edwin Silver of DepoLink Court Reporting.

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MODERATOR: What exactly is a franchise and why should counsel be concerned with franchise law?

LEVIN: The definition of a franchise comes up in two different contexts. One is disclosure and registration: What are a franchisor's disclosure obligations under the Federal Trade Commission's now-revised Franchise Rule and under state franchise laws? The second is relationship laws. Some states regulate the conduct of the franchise relationship, principally in the area of termination and renewal of franchises. Some states also regulate other aspects of the relationship between the franchisor and franchisee.

TRACTENBERG: Why is the franchise relationship regulated as opposed to a lot of business relationships and contracts that aren't? When Congress was revising the securities laws, it looked at franchises because they are similar in that they can be an investment; on the other hand, franchises are controlled very differently because the franchisee actually participates and is able to earn money, and Congress decided to regulate franchising separately. Once the federal regulators became involved, the state regulators became involved, and now we have this patchwork quilt of legislation that we franchise lawyers are trying desperately to resolve so that there can be clarity in the definition of what a franchise is and how businesses can expand through franchising.

SIEGELHEIM: The definition of a franchise really depends on what state you're in. New Jersey uses a community-of-interest standard. Essentially, you're requiring a franchisee to invest substantial amounts of money which in part go to the ultimate success of the franchisor. This investment also has minimal or no utility outside of the franchise investment. For example, if a restaurant concept requires the franchisee to spend large amounts of money to build out a restaurant, but upon termination the franchisee is not permitted to operate another restaurant concept, then the community-of-interest standard would likely be satisfied. Contrast this with a hardware store when the manufacturer of a certain product cancels its agreement to permit the store to carry any of its products. Assuming that the hardware store can carry similar products, its prior investment still has utility and the community-of-interest standard would not be met.

EINBINDER: The relationship-law standard that Adam refers to relates substantially to termination and renewal matters. When you're talking about disclosure, there's an overall FTC requirement that franchisors provide a disclosure document that has a substantial amount of information about the franchise investment. In New York, California, Illinois and several other states, you have to file this document with the state registrar to get approval before you can sell franchises. New Jersey and Penns-ylvania don't have registration requirements. They follow the FTC regulations.

FISHER: People believe they can choose between being a licensee or a franchisee. They see a franchise as part of a regulated industry with a lot of red tape, and somebody told them that they can somehow do a license that isn't a franchise. Under the FTC Franchise Rule you're a franchise if you meet three elements: you have a trademark, you receive a payment of over $500 in the first six months, and you give sales and marketing assistance. If you have licensed a trademark, you have a hard time arguing that you don't give sales and marketing assistance, and $500 is a very low threshold, so it's very likely that the relationship they're describing as something else is in fact a franchise. As a franchisor you need audited financial statements, you need the presale franchise disclosure document and, most importantly, the earnings information you can give to prospects is limited. If you are a franchise, you can only make earnings representations about either the historical performance of your existing franchise or company stores, or a projection of how the franchisee will perform, if you do it in the disclosure document, according to regulations, with all the bells and whistles. So if you are a franchise, and particularly if you're a franchise and you didn't know you were a franchise, you're probably not following these rules.

LEVIN: The hard part is the third element, the significant control or assistance that the franchisor is either imposing on or giving to the franchisee. You're letting somebody use your mark and taking money; that's why you're entering into the relationship. What else are you doing for them? How reliant is the franchisee on the franchisor? You look at the marketing and sales, the training, the ongoing assistance in selling the products or offering the services. It's through that factual analysis that you determine whether or not you have a franchise relationship.

EINBINDER: A complicating factor is that New York doesn't require all three.

LEVIN: Neither does Virginia. But even if there are small exceptions, it still boils down to a fact analysis. At the federal level, it's significant control or assistance. At the state level, it's typically examining the marketing plan or system prescribed by the franchisor.

BRADY: The analysis is a little bit different in the litigation context. By the time a lawsuit is started, the decisions that define the relationship have already been made; the parties have already done the things that either make them a franchise or not. Also, the answer is going to be different depending on which state law governs the relationship. As a litigator, I often wish I could have helped draft the

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agreements, to take different state regulations into account. For example, New Jersey doesn't require payment of an initial franchise fee for a business to be deemed a franchise. This is a major distinction from most jurisdictions, where people often rely on the absence of such a fee to make their relationship a license rather than a franchise. Unfortunately, when these parties end up in litigation in New Jersey, they find out they actually have a franchise — and that is a problem.

TRACTENBERG: I tell clients, "Licensing is a one-way street. You license, and you receive money back. Franchising is a two-way street. You franchise and you get money back, but you have to keep giving and they have to keep giving." When counseling companies, you really want to emphasize that the contract has to be clear. It's not nearly enough to say that it's not a franchise. You might have to disclaim certain elements of the franchise, and even that's sometimes not sufficient.

SIEGELHEIM: Whether licensing is even an option depends on your client's business interests. If you're a greeting card business, where you're just looking for a distribution center to sell your cards, you don't necessarily care if they sell competitors' cards as long as you have an outlet, and the licensing model will work. If you have a restaurant concept, it's not going to work, because chances are you're going to want much more control over how things are prepared and distributed. We advise our clients to carefully consider the level of control they intend to exercise over their units before making a decision as to whether to license or franchise their concept.

BRADY: Another common misunderstanding about what makes a franchise involves the fee for service. People often think of such payments in terms of a traditional franchise, such as a hotel or fast food restaurant, and the payment of a recurring monthly fee or license fee. This is an outdated view. Companies should be aware that if there is any payment to the putative franchisor related to the goods they are selling to the putative franchisee, or for services provided to the putative franchisee, in many jurisdictions that is going to be deemed a fee for service.

EINBINDER: Most of the people I see who are expanding a business want to avoid franchising because of the regulations and costs associated with it. All of us have had someone come to them and say, "I want to do a license. We'll call it a joint venture. He'll work for me, but he's going to invest $100,000 and he's going to pay me $25,000 for the privilege, and he's going to use my name. He's not a franchisee, is he?" New York just requires either a trademark or marketing system plus a fee, and then you've got a franchise. A lot of people get caught up in this.

TRACTENBERG: One of the consequences of being a franchise versus not being a franchise, particularly in New Jersey, is that if you are a franchisor in New Jersey, your franchisee basically has a franchise for life. It cannot be terminated except for good cause, which means a substantial breach by the franchisee. It must renewed. If we're not in New Jersey and a business arrangement turns out to be a franchise under federal or state regulations, then often the franchisee is entitled to rescission, and that could have dire economic consequences for the franchisor. You have to understand that, in a state like New Jersey, the person you license has an evergreen agreement, and you should charge accordingly for it.

LEVIN: New Jersey and Pennsylvania do not have franchise disclosure laws. New Jersey has a Franchise Practices Act, and Pennsylvania has case law that's a little in mushy defining a franchise. But a lot of us, especially in New Jersey, have seen situations where a dealer has a contract that's terminable at will and upon the expiration of the term, this dealer has used one product most of his life, or 80 percent of the products he sells are from one manufacturer; the manufacturer decides to sell directly to the customers, or they change the pricing so that it's not profitable for the dealer to sell the product anymore. The dealer comes to the attorney and asks, "Is this a franchise? I've put my heart and soul into this, and my business is identified with this manufacturer's trade-

mark. I promoted his mark and built up all this goodwill, and now they're changing the rules of the game." You may not think the relationship is a franchise but, at least in New Jersey, the more relationship you can show, the better chance you will have to tell your story to a court. It's a very common problem in New Jersey because of the Franchise Prctices Act.

EINBINDER: It's the small guys, the single-unit operators, who are really buying a job. They're spending hundreds of thousands of dollars, much of it in home equity. They are, by and large, inexperienced, and are more likely than not to fail. The operators that are really successful are people who own a number of units.

BRADY: There are some real benefits to having a franchise that make it easier for a small-business person to be successful, such as providing access to established trademarks, products and even business models. This, however, does not guarantee a successful venture. The synergies are good for both sides when you have multiunit franchisees who have demonstrated that they can run a successful business.

SIEGELHEIM: You have to be very deliberate when you're developing a strategy for multiunits. The worst thing you can do is to give someone too liberal a development agreement, where there are not enough checks and balances, and controls, such as performance requirements or a development schedule, and where you are unable to reclaim the territory if they're not meeting certain benchmarks.

FISHER: We've talked about how to avoid being a franchise, but franchising really gives you a great way to teach somebody your super secret-stuff in a way that allows you to protect it, prevent its misuse and pretty much regulate the relationship. If you have a franchise, harness it, exploit it, and absolutely comply with the regulatory scheme so that you can actually enforce the relationship.

LEVIN: In many respects the initial success of franchising was because of charismatic figures who drove the business, like Ray Kroc of McDonald's. The trend is now toward the large multiunit-operator system. In addition, private equity is changing the dynamics of franchising, because now you have owners of franchise companies with different expectations. They have their own five- and seven-year exit strategies. Large multiunit franchisees also have exit strategies. How this will affect franchising as a whole is still to be determined.

TRACTENBERG: Private equity is the big investment vehicle now because it's cheaper in the short run than borrowing from a bank, and there is less regulation than with a stock offering. More importantly, the investor doesn't have to file quarterly reports or show improving quarterly results. Franchising in and of itself leverages other people's talents and money. A private equity investment in a franchisor is simply leveraging *that* business model. Private equity companies are also investing in the multiunit franchisees.

BRADY: Problems typically develop when the private equity company completely takes over the operations of the company and the individual who developed the concept and made it successful is pushed aside. Then you may be faced with a whole host of problems from angry franchisees who invested in a concept that they believed in but are now being forced in a different direction, or who are looking for leadership and direction from an organization that is no longer equipped to provide it.

SIEGELHEIM: It's obviously appealing to some investors that they can come in and drive the bus. The cash flow and other benchmarks warrant the investment, but there are some operational deficiencies that they can correct with the right people in place and then take things to the next level. We have had clients say flat out, "We're not taking this any further. We've pretty much built it out as far as we can, and we're excited to have these people come in. They're going to have resources that we don't have, and we feel that this can grow beyond where we can take it."

EINBINDER: I've seen companies buy into franchise operations and change the way things have operated for 20 years. They don't really understand the franchise dynamics. There's a lot of due diligence to be done in advising a client who is buying a franchise system — not only in looking at the numbers, but also at the relationships. There's a whole group of people out there called franchisees who want to make sure there isn't too much change for what they view as being just for the sake of change. I represented a group of franchisees in a system that was sold after 10 years in operation. Every one of their agreements was coming up for renewal. To my utter surprise, the company that bought the system never once spoke to any of the franchisees to find out what the system was like. I think they were looking at where they could tweak more profits out of it, and nothing else.

SIEGELHEIM: The flip side of that is, "We're never going to change the culture because that is going to send shock waves through the existing franchisees and cause problems." However, that may not mean a positive result for the new ownership or the existing

franchisees. In some systems, the franchisees may want the shake up. They may not be upset that the culture is changing.

EINBINDER: There are a number of systems where franchisees look at this as an opportunity to leverage a better deal with the franchisors.

LEVIN: Don't you think it boils down to franchisees looking to the new owners of the franchise system and asking, "How will this affect my business"? I find that when franchisors are transparent with their franchisees, and communicate what they are going to do, and why, it usually works.

EINBINDER: Absolutely, 100 percent. The thing is that a lot of systems don't do that. Just selling it because it's a cash flow deal and nothing else works horribly.

MODERATOR: Which issues commonly lead to disputes between franchisors and franchisees?

FISHER: Nonpayment of the franchise fee is the biggest by far.

EINBINDER: If it's a franchisee suing a franchisor, nine times out of 10 it's about being provided information, before they acquired the franchise, about how much money they could earn. It's about expectations.

FISHER: There is a higher incidence of those kinds of claims in systems which don't make voluntary financial performance representations. Most financial performance representations are based on historical performance rather than on projections because of the greater liability associated with the latter. Although some suggest that even historical claims expose a franchisor to liability, in reality they make it difficult for a franchisee to prevail on a claim that he relied on overly ambitious earnings information from a rogue salesman, when faced with lower actual results reported in the financial performance representation.

LEVIN: You don't see earnings claim cases in New Jersey and Pennsylvania because they don't have state statutes that regulate disclosure.

EINBINDER: But a franchisor based in New Jersey who sells to somebody in New York or California or Illinois or can still apply the law of New York if the franchise is located in New York.

SIEGELHEIM: There's a 1986 Law Division case (our trial court level) that says that if you violate the FTC Franchise Rule it's a per se violation of the New Jersey Consumer Fraud Act and you're liable for treble damages and attorneys fees. It's never gone up on appeal.

LEVIN: There are several federal court cases that said the opposite. It's not really clear whether you can bring a successful consumer fraud claim in New Jersey based on a violation of the FTC disclosure requirements.

SIEGELHEIM: Right. In addition, the Law Division case is only persuasive, and not binding on other New Jersey courts.

LEVIN: It's amazing to me that 21 years after *Morgan v. Air Brook Limousine* there is not a clear-cut remedy in New Jersey under the FTC Franchise Rule for someone who has been given false or misleading information in violation of the FTC disclosure requirements.

BRADY: The reality is that we don't have a ruling about whether the Law Division opinion is good law because so many of these cases get resolved prior to trial. What we do know is that there is a colorable basis for a franchisee to bring a false earnings claim under the Consumer Fraud Act.

TRACTENBERG: Lane and I represented a group of franchisees against an unscrupulous franchisor in New Jersey. We were able to convince a court of law of a fraud; more importantly, the Federal Trade Commission was convinced of a fraud and enjoined the transfer of funds overseas by this franchisor, and the promoters of the franchisor were punished. The FTC regulations establish a duty of care that is breached when unlawful earnings projections are given; because that misrepresentation is actionable, it's common law fraud under New Jersey law. So there is a remedy. But maybe we ought to force franchisees to actually get legal counsel before they enter into these relationships, so that they can make knowing and intelligent decisions.

LEVIN: On the other hand, we have all had franchisees come to us with horror stories about what they were told and how they took their 401(k) plan and put it into a system that was really just churning franchises.

SIEGELHEIM: It's difficult to explain to your client why they have gone through the trouble of complying with these regulations when they see an unscrupulous competitor calling its agreement a license in an attempt to avoid complying with the franchise regulations — even though they are clearly offering franchises. The client feels that their competitor is getting away with it, and there's no remedy because there's no private right of action.

MODERATOR: How do you handle dispute resolution issues in a franchise agreement?

BRADY: Dispute resolution is jurisdiction specific. For a whole host of reasons, franchisors should build forum selection and choice-of-law provisions into their agreements to allow litigation arising out of the contract to take place in the franchisor's jurisdiction, applying the franchise law of that state. For example, if you are dealing with a franchisee in New Jersey, the state Franchise Practices Act is going to invalidate a forum selection clause that calls for litigation outside of the state. So if you are a franchisor entering an agreement with a franchisee in New Jersey, you might want to create some creative clauses that will at least allow you to pick the best forum in New Jersey for your circumstances.

SIEGELHEIM: If a franchisee brings a Franchise Practices Act claim in New Jersey, typically a forum selection clause that requires a franchisee to sue in a court in a franchisor's home state will not be enforced — with the exception of arbitration. Arbitration is governed by the Federal Arbitration Act.

EINBINDER: From a franchisee's perspective, my general preference is to avoid arbitration clauses. You pay $250 to file in federal court; you pay $8,500 to file an arbitration. There's no appeal and there's no jury — which is something that many franchisees want. The franchisee, who doesn't have money to begin with — having lost everything in the franchise deal — is going to have to pay a lawyer, or half of one lawyer or half of three lawyers, and I've seen cases get completely out of hand with arbitrators who were in it to generate more fees. I hate it as a method of dispute resolution, but you may want to counsel a franchisor to include an arbitration provision in a contract to avoid a claim by a franchisee. That's something you've got to tell the franchisee client, too.

FISHER: The real consequence is that once an arbitration or litigation is filed, it often has to be disclosed in the franchisor's franchise disclosure document and will complicate future validation by new candidates. The object is to preserve the revenue stream associated with that unit in a way that protects your brand, and to work folks out of your system who are not right for your system in a way that doesn't trigger any ugly, long-term disclosures. If parties act promptly and mediate their disputes, they have a greater chance of minimizing the impact of any disclosure.

LEVIN: Years ago the idea was that arbitration favored franchisees and was less expensive, less time-consuming and less cumbersome than litigation. That turned out not to be the case. I used to favor arbitration clauses in franchise agreements, but now I do not put them in because I don't think arbitration is an effective dispute resolution mechanism.

BRADY: If you choose to go with a form of alternative dispute resolution, it is a good idea to reserve the right to go to court if you need some sort of expedited injunctive relief. For example, if a franchisee continues to use the franchisor's trademarks after the franchise agreement is terminated, you may want to be able to get into court and make sure those signs come down. If you just have a basic run-of-the-mill arbitration clause, that is not going to happen, because you will be required to arbitrate that dispute.

LEVIN: One advantage of arbitration clauses is forum selection. At least in New Jersey, if you have a franchisor who wants to make sure that a dispute is resolved in the state, you put in an arbitration clause. But I don't know if that's the tail wagging the dog.

FISHER: In many cases, the place where the matter will be tried is outcome determinative. The one that has to travel is typically at a disadvantage from a cost and convenience standpoint, and will need to factor in these anticipated costs in negotiating a settlement.

TRACTENBERG: I'm in the minority. For large chains, I recommend arbitration clauses because the large brand could be subject to a huge verdict with a runaway jury, especially if you have to litigate outside your hometown. The arbitration clause assures two things: one, that you probably will have a venue that's heard of and might even enjoy your brand; the second is that you won't have a runaway jury, and you're likely to have someone who will not be subject to passion in determining how much is owed. I agree that arbitration can be inefficient, but sometimes it can be very efficient. It avoids appeals. During the arbitration you can also have mediation. I think that with an injunction carve-out, which is reciprocal — even a franchisee can get an injunction — arbitration is beneficial. The parties can choose not to arbitrate.

SIEGELHEIM: When I'm drafting an agreement, I usually ask our litigation group what their thoughts are regarding arbitration. One of the concerns they've expressed is that in an arbitration your discovery rights may be considerably more limited than the discovery that you would be entitled to had the claim been filed in state or federal court. And the arbitrator's final decision is difficult to appeal. So the flip side is that a large franchise system may get a verdict against it that's not based on full discovery and then have a limited right to appeal.

FISHER: The perception years ago was that arbitrators tend to cut the baby in half, so you could do some damage analysis and figure out where you might end up. Now they definitely throw the book at somebody, and you can lose a substantial judgment and have virtually no appeal right. And I'm seeing arbitrators award relief that may or may not even be authorized under the statute in question. Our firm has had great success in resolving claims through early mediation. Often much of the emotion which fuels a dispute dissipates when the franchisee gets to tell his story to a mediator, in a courtroom-like setting. It doesn't have to be to a judge, just somebody dressed like a judge.

EINBINDER: Pre-arbitration or pre-litigation mediation is wonderful for everybody and gives the franchisor the opportunity to resolve a dispute before they have to put it on the docket.

BRADY: Mediation is fantastic, especially in situations where the franchisor is the plaintiff. An early mediation is the most likely situation to allow for a positive business resolution of the matter.

EINBINDER: I have had more luck resolving cases after people have spent tens of thousands of dollars litigating or arbitrating — when they've found out what the litigation or arbitration process is like.

LEVIN: That's what my litigation partners tell me: "Don't have mediation. Have some discovery and sort things out."

EINBINDER: Check each other out for a while and spend some money.

BRADY: I disagree. Typically, the franchisee is the one that's going to be cash-strapped, and the time to do it is early on, so there is a possibility that they can continue their business or work out some sort of payment. If the franchisee spends the last of its resources on discovery, what good is a judgment that cannot be collected upon?

FISHER: Or they show you the napkin. They show you the smoking gun. They show you the thing in arbitration or in mediation that you may not have seen otherwise.

TRACTENBERG: I see mediation as evidence of the franchisor's failed attempt to resolve the case. A franchisor should make every effort to meet with and to communicate with the franchisee to resolve a dispute, especially if the franchisor desires to preserve the relationship. And if the franchisee can't educate the franchisor as to why its position should be accepted, why go before a third party? Is there that much friction in the relationship that you can't communicate directly with each other?

FISHER: At that level a lot of disputes are because you've selected the wrong guy or gal for the seat, and you can either go to war with each other or assist in working the franchisee out of the system through a resale. This forces your adversary to say good things about you and the franchise, because they want to sell their unit and recapture their investment. It's a way to get everybody on the same page.

ROBERT C. BRADY focuses on complex business and commercial litigation in federal and state court, handling diverse matters that include franchise and licensing disputes, financial services litigation, restrictive covenants and non-compete/non-solicitation agreements, shareholder derivative actions, class actions, and contract disputes, as well as expedited litigation and injunction proceedings. Fully conversant with New York and New Jersey federal and state court procedures, Mr. Brady handles pre-trial discovery, trials, appeals, and post-judgment enforcement proceedings. He is co-chair of the Federal Practice Committee of the Essex County Bar Association and an adjunct professor of law at Seton Hall University, teaching appellate advocacy.

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