

FRANCHISE LAW INSIDER™

A Publication Reviewing Recent Franchise Developments

October 1999



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FRANCHISE LAW

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“All serious daring starts from within”

- Eudora Welty

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STATE-OF-THE-ART AGREEMENTS: PERFORMANCE CLAUSES

Franchise agreements aren't static documents. Just as any professional Franchisor is regularly revising and developing its marketing, operational and financial systems to respond to competitive challenges and opportunities, the core documents used by a Franchisor will change to reflect developments and new techniques presented in the legal area.

One area where our agreements have changed over the past few years, and which seems to have met with broad market acceptance, is the inclusion of "performance clauses" in the franchise agreement.

These clauses developed from an observation that any well-managed distribution network (which is what a franchise system ultimately is) will monitor the performance of each of its units. We saw that nearly all distribution networks operate on the principle that if a unit fails to meet operating standards, or fails to meet reasonable financial targets, the owner of the brand will work with the distributor to

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“The problem is addressed as a mutual problem that needs coordinated effort of both the Franchisee and the Franchisor to correct.”

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FRANCHISE LAW INSIDER

FRANCHISE LAW INSIDER™ is published periodically to provide our clients and friends with information on recent legal developments affecting the franchising world. The articles and/or opinions presented are necessarily of a general nature and should not be construed as legal advice or opinions on specific facts.

We'll be happy to provide additional information regarding any of the articles contained herein, or to discuss how they may apply to your situation.

We invite your comments, questions, or any short articles of a pertinent nature for possible inclusion in a future newsletter. Please contact our offices if you're interested.



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solve the problems. However, if the noncompliance situation cannot be successfully resolved, the brand owner will retain the right appoint a new distributor.

It was our conclusion that these same principles applied in franchising and that a way was needed to be found to implement them in an environment where the Franchisee owns his or her business. What was particularly important was to both utilize objective criteria for evaluating Franchisee performance and minimizing the chances for lengthy and expensive legal battles.

After a series of drafting exercises, what emerged were the performance clauses that a number of our clients now use. Here's how they work:

System Compliance

The performance clause focuses on two areas: operational compliance and financial performance. Operational compliance is concerned with system standards (cleanliness, quality, customer service, etc.) The franchised store is regularly inspected and evaluated (including, field service visits, customer comment cards and secret shopper reports) for compliance with system standards, using the same methodology and scoring system as for company-owned stores.

Note that the measuring point here is company-owned stores, not other franchised units, so as to avoid a "lowest common denominator" situation. The franchised store is given system standards score in each major category and compared with the average scores in each such category as achieved by company-owned units. Also, what's critical here is that objective criteria are used and the same standards are applied to company-owned stores, undercutting any claim of bias or prejudicial treatment.

Financial Performance

Every six (6) months, a comparison is made of the Franchisee's gross volume with a percentage of average system-wide per unit gross volume, on an escalating basis. For example, during the first year of a franchised unit's existence, it might be required to meet 50% of the average per unit volume, during the second year of a franchised unit's existence, it might be required to meet 60% of the average per unit volume, etc. However, the financial target is capped at a number less than average system-wide per unit gross volume (for example 75%) so that a Franchisee's financial performance can be less than average and still be acceptable.

The Correction Process

If the Franchisee fails to meet the standards for either system compliance or financial performance, a six-month correction process is initiated. During that time, the Franchisor actively works with the Franchisee to (a) identify the reasons for the substandard performance, and (b) suggest methods for resolving the problem. In addition, the Franchisor can require the Franchisee to meet with the Franchisor at

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FRANCHISOR HELD RESPONSIBLE FOR CRIMINAL ACTS OF FRANCHISEE'S EMPLOYEE: IS YOUR FRANCHISE SYSTEM AT RISK?

By Brian Beckwith

"If the franchisor had only required a background check, this would have never happened." These are the very last words that a franchisor would want to hear from opposing counsel in a lawsuit over the franchisor's responsibility for the criminal actions of one of its franchisee's employees. Unfortunately, these words, or ones very similar, were heard in December of 1998, in *Read v. The Scott Fetzer Co. d/b/a The Kirby Co.* The Texas Supreme Court held Kirby, a vacuum cleaner manufacturer, liable for the injuries caused by a salesperson of one of its distributors. During an in-home demonstration, which was the required method of sales outlined in the Kirby "Distributor Agreement," the salesperson sexually assaulted one of the distributor's customers.

While Kirby argued that it had successfully separated itself from the independent dealers through their franchise agreement, the court saw it differently. The court found that because of the way the Kirby "Distributor Agreement" was set up,

"Is your franchise system at risk for some of the same exposure that Kirby faced?"

Kirby had retained control over how the vacuum cleaners were to be sold (via in-home demonstrations) thereby creating a duty for Kirby to take reasonable measures to insure the safety of its customers. Had Kirby required the distributor (similar in function to a

franchisee) to conduct a background check of the employee who committed the assault, they would have (presumably) found that the employee had a history of complaints of sexually inappropriate behavior and had been arrested on a charge of

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the headquarters to analyze the reasons for the substandard performance, discuss possible means of correction and/or re-attend training. The problem is addressed as a mutual problem that needs coordinated effort of both the Franchisee and the Franchisor to correct.

If the problem is resolved, nothing further need happen. On the other hand, if the six-month period passes and the situation still exists, then the Franchisee is given an additional 90 day period to sell his unit.

Evaluation

To date, these performance standard clause seems to have met wide acceptance, with franchise

marketing professionals reporting few, if any, instances of resistance by prospects. This may well be because few prospective Franchisees believe (or are willing to admit) that they will be sub-average in performance.

The great advantage of the performance clause is, of course, that it gives Franchisors a pre-designed methodology for continually weeding out poor performers, allows them to recover their investment and avoids legal battles over termination for default.

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indecent with a minor. The court stated that, "Kirby was negligent in its own conduct of creating an in-home marketing system without adequate safeguards to eliminate dangerous salespersons from its sales force. The duty is not based on the notion of vicarious liability, but upon the premise that Kirby is responsible for its own actions."

While a motion for rehearing was filed, and supported by a number of industries through amicus curiae briefs, the Texas Supreme Court denied the motion in June of this year. So, for now, the doctrine of retained control stands as the test of a franchisor's responsibilities toward the safety of third parties, at least in Texas.

Is your franchise system at risk for some of the same exposure that Kirby faced? We feel that the businesses that are most at risk are ones that involve the entering of the franchisee's employees into another's home. Businesses such as home repair, delivery, door-to-door sales, in-home health care, maid services and appliance repair or demonstrations are some examples. But, this list could also include any business that where a third party is injured by the acts of a franchisee or its employees. Consider the (hypothetical) situation where customer is shot by a distraught pizza delivery person. This third party customer could file suit against the franchisor, and possibly win under the case law set by *Kirby*, even though the franchisor had no part in the actual hiring or training of the assailant who committed the crime. This is one of the many possible scenarios that one could think of and one of many reasons why the *Kirby* decision may have such a tremendous impact on franchising in the state of Texas and possibly elsewhere if the *Kirby* standard is adhered to in other jurisdictions.

Here are some questions that you should ask yourself regarding the level of exposure that your franchise system may have:

- What requirements do you place on your franchisees to check into the background of who they are hiring? How are these policies monitored and enforced? What are the consequences if the franchisee does not comply?
- Is there language in your Franchise Agreement that provides for indemnities and disclaimers against liabilities?
- Is the franchisee required to maintain insurance for injuries occurring to third parties? Does the insurance company understand how your

franchise system works in terms of the relation between the franchisor and franchisee and what duties and responsibilities are owed toward each other?

- Does your franchise system provide for a safe environment for business to be conducted? Are follow-ups performed when a service is rendered? Are adequate warnings and safety equipment in place and being implemented?

You, as a franchisor, will want to carefully consider what hiring

and training procedures you require of your franchisees and put them on notice of the consequences they will face if they do not comply. Even the most carefully constructed franchise agreement cannot prevent third party injuries from occurring. But there are things that you can do to minimize that risk. Along with the suggestions mentioned above, seeking the advice of experienced human resources or employment law counsel may assist you in the decisions you make regarding your policies on employment screening. As the *Kirby* case makes very clear, an ounce of prevention is worth a pound of cure.

Brian Beckwith joined the firm last June as a paralegal.

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LEGISLATION, REGULATION AND COURT CASES

FEDERAL REGULATIONS

FTC Provides Advice on Disclosure Requirements for “Business Consultants”

A recent Federal Trade Commission informal staff advisory opinion provides guidance with respect to the obligations of various “business consultants” involved in the franchise award process to deliver franchise disclosure documents to prospective franchisees with whom they meet. While the conclusions reached by the FTC staff are not binding on the FTC or any court, and aren’t surprising to experienced franchise counsel, they provide appropriate guidance for Franchisors and those involved in the franchise award process.

The informal staff advisory opinion was the result of an inquiry on behalf of a firm representing several unnamed franchisors. These franchisors have contracts with various independent “business consultants” or broker networks, where the “consultant” is engaged to present the franchise opportunity to prospective franchisees (including presentation of brochures and other sales materials) and is compensated by the franchisor when the prospect purchases a franchise.

Such “consultants” typically interview the prospect and attempt to match the prospect to an appropriate franchise system, using financial and (sometimes) psychological and other guidelines. Qualified prospects are referred to the franchisor and further communications are generally directly between the franchisor and the prospective franchisee, with the “consultant” having little (if any) further involvement other than the possibility of receiving a commission or referral fee.

The question addressed by the staff opinion was whether the “consultant’s” activities required the consultant to deliver a disclosure document (such as the UFOC) at the time that the consultant suggests

that the prospect might be interested in a particular franchise. The staff concluded that UFOC delivery was required to be made by the “consultant.”

The FTC Franchise Rule requires “any franchisor or franchise broker” to furnish an appropriate disclosure document at the earlier of “the time for making disclosures” or the first “personal meeting.” “Franchise broker” is defined as “any person other than a franchisor ... who ... offers for sale, or arranges for the sale of a franchise.”

Notwithstanding the claims by some “business consultants” or marketing networks that they are not “brokers” and merely place qualified prospects in contact with appropriate franchise systems, the better view (and the one adopted by the FTC staff) seems to be that such consultants or networks clearly are involved in the franchise award process and, at a minimum, help “arrange” for the sale of a franchise, thereby triggering the requirement that they deliver a UFOC when they meet with a prospect.

The staff’s opinion is further supported by the Statement of Basis and Purpose accompanying the FTC Franchise Rule, where the Commission found that “(t)he public record clearly indicates that franchisees who purchase franchises from franchise brokers or promoters need protection as much as those who purchase (directly) from the franchisor itself.” Since the “consultant” has an economic incentive to “sell” the franchise and might be tempted to make misrepresentations, the wisdom of requiring presentation of a UFOC seems at least as appropriate in the case of outside “consultants” as with persons employed by the franchisor.

In fact, it would seem strange to have a situation where prospect A, meeting with an full-time employed salesperson of the franchisor, receives a UFOC at the meeting, while prospect B, meeting with a “consultant” and receiving a similar sales

“UFOC delivery was required to be made by the ‘consultant’ ”

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presentation, is not provided with the UFOC at exactly the same type of meeting.

Once one agrees that providing disclosures at the first personal meeting is necessary in order to protect prospective Franchisees, it's difficult to make a convincing argument that the two situations should not be treated similarly, particularly when the burden of providing the disclosure is relatively easily met (the consultant simply keeps on hand UFOCs for the systems he or she is representing), as compared to the benefit to the prospective franchisee.

Of course, it is possible to make a reasoned argument that franchise disclosure rules should simply require that a UFOC be delivered a minimum number of days before closing, and dispense with a requirement for delivery at the marketing meeting. Sadly, this approach is not allowed under the FTC Rule (or the laws of at least some states) and there appears to be no prospect of such a change in the near future.

Prudent Franchisors should, in the light of the staff opinion, verify that all of their marketing personnel, including outside organizations, are properly delivering UFOCs and receiving signed receipts (forwarded to the Franchisor) since a violation by the "consultant" can result in legal exposure for the Franchisor. Franchisors should also focus on the question of whether such "consultants" are "franchise brokers" for purposes of UFOC Item 2 and 3 disclosures and the registration requirements of various states.

COURT CASES

Arbitration Clause Foils Class Action

One of the most dreaded prospects for any Franchisor is the possibility of being confronted with a class action by its Franchisees. A class action could be incredibly disruptive to ongoing business, would be a severe negative marketing factor in any UFOC disclosure, would cost hundreds of thousands of dollars to defend, would expose the Franchisor to significant damages (and the possibility of paying the Franchisee's attorney's

bills) and would be tried before a jury that might identify with individual Franchisees and would have little familiarity with the needs of a franchise system.

To avoid this prospect, many Franchisors include clauses in their franchise agreements requiring arbitration and, going beyond that, mandating that any arbitration be on an individual basis only, with no class actions allowed.

How successful are these clauses and will a court actually uphold them? A federal appeals court in Chicago has recently answered that question, at least partially, ruling that the Franchisees were required to arbitrate their claims against the Franchisor, overturning a contrary state court ruling.

The case was *We Care Hair Development v. Engen* (CCH Bus. Fran. Guide ¶ 11,646) involving claims by various Franchisees that the Franchisor had violated state franchise and anti-trust laws. The court determined that the arbitration

clauses were fully enforceable against the Franchisees, even though provisions in various leases would have allowed the Franchisor to litigate eviction actions in court, rather than through arbitration.

The court also noted that the arbitration clauses (and their possible enforcement) were not a surprise to the Franchisees, many of whom were experienced business people and who had received a UFOC disclosing the existence of the arbitration provision, as well as the possibility of eviction actions.

While arbitration clauses may continue to be challenged, the trend of most of the cases seems to be to enforce them, consistent with federal policy on the issue. Prudent Franchisors will continue to insert arbitration provisions, and "anti-class action" language, in their documents.

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STOPPING COMPETITION FROM FORMER FRANCHISEES

(Part 1)

The many people who receive this newsletter are often some of the best sources for ideas for new articles. And one of the most enjoyable things we do is to respond to their suggestions.

A perfect example of that occurred recently when one of our readers (the President of a national Franchisor) asked us to do a series of articles detailing how other franchise systems stop ex-franchisees from competing with company-owned or franchised units when the former franchisees have left the system.

The problem is certainly a legitimate one and probably occurs in almost all franchise systems. A franchisee can leave the system through a variety of means: termination for default, voluntary termination, repurchase by the Franchisor of the franchise and/or the associated retail business, assignment by the old Franchisee to a new Franchisee, abandonment or otherwise. In fact, the way that the Franchisee leaves the system may have some impact on the legal means used by the Franchisor to limit further competition.

The Franchisor's primary line of defense has been the non-competition clause in the Franchise Agreement. Normally, a well-drafted clause will have prohibitions against both "in-term" competition (competition while the Franchise Agreement is still in effect - the Franchisee opening a competing business while he or she is still part of the franchised system) as well as "post-term" competition (operating a competing business after the franchise has been terminated or expires.)

In most situations, courts have consistently supported the Franchisor's right to prevent in-term competition. Even the most Franchisee-friendly

states and courts (including those in California) see that a franchise system would face severe problems if Franchisees could operate competing concepts while they were still part of a system.

Not only would there be opportunities for fraud on the part of the Franchisee in economically sensitive areas ("That sale really took place over at my non-franchised outlet, so I don't actually owe any royalties on it!"), if a Franchisee could use operating and marketing techniques learned as part of a franchised system to benefit his or her non-franchised outlet, an inherently unjust situation would exist, one that would offend those Franchisees who have an exclusive commitment to the system and make them unlikely to share innovations.

Questions of loyalty would arise, such as in the case of a Franchisee who wanted to expand and acquire a

particularly favorable location. Would he/she operate that location as a franchised or non-franchised outlet? Suppose it's the only triple-A location in the market? Would they suggest that customers drawn to the franchised location due to its brand recognition factor patronize the non-franchised location ("Our products down the street are just as good"), avoiding royalty and marketing contribution requirements, as well as franchise system controls?

For all of these reasons, well written in-term non-competition agreements are almost always enforced by arbitrators and courts. Enforcement of non-competition agreements after the franchise relationship has ended pose more difficult problems, which we'll explore in our next issue, along with suggesting some solutions.

Look for Part 2 of this article in the January 2000 FRANCHISE LAW INSIDER™.

"In most situations, courts have consistently supported the Franchisor's right to prevent in-term competition."

INVESTIGATING WORKPLACE ISSUES

By Susan S. Waag, Esq.

When someone needs to have assets tracked or a person followed, they may call a licensed, private investigator. But when an employer is wondering how to investigate an employee's complaint of sexual harassment, race discrimination or some form of employee misconduct, whom should they call? Most private investigators do not understand the sensitive legal issues involved in handling a situation that could result in litigation. Instead, employers and their attorneys will often engage an independent human resources (HR) consultant to handle an investigation into a workplace complaint. While such consultants may have the expertise necessary to do an excellent job, there may be some hidden legal problems.

The California Department of Consumer Affairs (DCA) requires that anyone who investigates alleged misconduct or makes determinations of credibility for the benefit of an employer must obtain a private investigator's license. The law, known as the Private Investigator's Act, does not apply to investigations conducted by a bona fide employee of the employer or to an attorney at law.

Although HR consultants who conduct investigations without a private investigator's license may be fined by the DCA, the law does not impose any specific penalty on the employer who hires the unlicensed investigator. However, of potentially greater significance, an employee fired for misconduct may be able to challenge the validity of a harassment or discrimination investigation that was not conducted by a legally qualified investigator. This makes any actions or decisions by the employer based on the investigation vulnerable to attack.

The employer could avoid this problem by having a licensed attorney conduct the investigation. However, if there is litigation, the employer will need to present all or part of the investigation as evidence at trial. Even if the attorney-client-privileged matters could be compartmentalized, as

a witness in the case, this attorney would be precluded from representing the employer at trial.

Earlier this year, a new wrinkle was added. The federal Fair Credit Reporting Act (15 U.S.C. §§ 1681 et seq.) ("FCRA") requires disclosures to employees before an employer can obtain or use a consumer report or an investigative consumer report obtained through the use of a third party. In April, 1999, the Federal Trade Commission published an opinion letter concluding that a sexual harassment investigation conducted by a third party is an "investigative consumer report", and compliance with the FCRA is required. Such a report must be provided to the employee in unredacted form if it is used in any employment decisions. Several other notice and disclosure requirements would also apply. The letter is an opinion of the FTC's counsel; it is not binding on the FTC and its enforcement is uncertain. However, such an application of the FCRA would give rise to numerous concerns that could severely hamper legitimate investigations.

So, what should an employer do if it needs help with such an investigation? There are a few choices: (1) Find a licensed investigator who has specific expertise in workplace harassment and discrimination issues; (2) Identify an employee who could conduct the investigation (with the close and privileged advice of qualified employment counsel); or (3) find an independent employment attorney who can conduct the investigation with the understanding that his/her activities may be subject to litigation discovery.

If you use a third party to conduct the investigation, this person must be sensitive to any legal issues that could arise and know how to navigate in an area that, more often than not, presents a legal minefield.

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