

# FRANCHISE LAW INSIDER™

A Publication Reviewing Recent Franchise and Related Business Developments 1st Quarter 2005

**"The quickest way to failure  
is to try to please everybody."  
- P. Lorillard -**



**HOLMES & LOFSTROM, LLP**  
Franchise and Business Counsel

**IFA QUARTERLY EVENTS**  
Hosted by  
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**January 19, 2005**  
**PRACTICAL TO TACTICAL: SYSTEM  
MANAGEMENT & BEYOND...**

**LOCATIONS:**  
**Orange County Breakfast**

**New!** Scott's Seafood Bar & Grill  
3300 Bristol Street  
Costa Mesa, CA 92626  
7:30 am

**San Diego Dinner**

Franchise.com Office  
135 Saxony Road, Suite 200  
Encinitas, CA 92024  
6:00 pm

For more information please call  
Christine at:  
(562) 596-0116

**SOUTHERN CALIFORNIA**

6621 E. PCH, Suite 250  
Long Beach, California 90803  
Tel: (562) 596-0116  
Fax: (562) 596-0416  
Admin@HolmesLofstrom.com

**NORTHERN CALIFORNIA**

4251 S. Higuera Street, Suite 401  
San Luis Obispo, California 93401  
Tel: (805) 547-0697  
Fax: (805) 547-0716  
Info@HolmesLofstrom.com

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## CREATING A WINNING FRANCHISE CULTURE

**By: Gene Longobardi, Kidz Online International, Ltd.**

**E**very group of human beings that works together for some purpose develops a culture that serves to define the group and determine its degree of ultimate success or failure. Whether a business unit or department, a church or civic organization, sports team or classroom, a culture forms based on the human interactions, attitudes, values, perceptions and perspectives. The key issue facing business leaders with regard to culture is: Will my culture propel me to success or will it doom me to failure, or, worse yet, mediocrity?

While culture can be difficult to define, it is essential for the success of any business endeavor. Successful business leaders create and nurture a business culture that is properly aligned with and supports the mission and vision of the organization. Microsoft Corporation is an excellent example of a business that has created and sustained a unique and powerful culture that has made it one of the most successful businesses in the world.

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**In franchising, creating a winning culture can be even more difficult than in other business formats due to the inherent diversity in geography, language, nationalities, organization maturity levels and many other factors.**

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And yet, it is perhaps even more critical for franchise leaders to be purposeful and strategic about the culture they create in their system.

Without a defined strategy and purposeful effort to create and sustain the right culture, franchise business leaders run the risk of a random, and potentially destructive culture being formed in the organization. Once the wrong culture has been allowed to grow, changing it can be close to impossible and at best will take years.

Franchise organizations that build a winning culture will realize the following benefits:

- Greater unity and consistency within the system, as franchisees are selected to match the desired business culture and the system reinforces appropriate behavior and norms.
- Standards of performance and benchmarks will be easier to implement and more readily accepted.

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# FRANCHISE LAW INSIDER™

FRANCHISE LAW INSIDER™ is published 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're 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.



## HOLMES & LOFSTROM, LLP Franchise and Business Counsel

### Attorneys

David E. Holmes, Partner  
Lori M. Lofstrom, Partner  
Margaret E. Narodick,  
Senior Counsel

### Of Counsel Attorneys

Steven D. Wiener  
Nicola J. McDowall  
John G. Haraldson

### Paralegals

Lynne C. Anderson  
Peggy J. Karavanich  
Catherine M. Carroll

### Administrative Staff

Jill A. Thiercof, Firm Administrator  
Christine C. Goldenberg,  
Administration & Events  
Richard Devine, Executive Assistant

For more information on the Franchise Law  
Insider and our legal services, contact us

by phone: (562) 596-0116

by e-mail:

[admin@HolmesLofstrom.com](mailto:admin@HolmesLofstrom.com)

Or visit our website:

[www.HolmesLofstrom.com](http://www.HolmesLofstrom.com)

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## WHAT'S NEW WITH US?

**Happy 2005!** This year, Holmes & Lofstrom is undergoing many new and exciting developments. With this newsletter we are introducing you to our new logo and some "new additions" to our firm! We anticipate the completion of our new website and all logo-bearing materials next month.

**Nicola J. McDowall** joined H&L in March 2004 as Of Counsel. Nicola comes to us with a wealth of knowledge and experience in both franchise and general business matters. She graduated from the University of Birmingham and The College of Law in Guildford, both in the U.K. For 4 years Nicola practiced commercial law in London and then came to California in October 1989, passing the California Bar in February 1990. For 19 years, Nicola has been involved in international transactional law, as well as, franchise sales, acquisitions and restructuring of franchise systems nationally and internationally, intellectual property portfolio management, operating system compliance issues, distribution and licensing arrangements, technology development and implementation issues and contract negotiations. She served as in house counsel for New Horizons Computer Learning Centers for almost 6 years. Contact Nicola at: [n.mcdowall@holmeslofstrom.com](mailto:n.mcdowall@holmeslofstrom.com)

**John G. Haraldson** is also Of Counsel to H&L joining us in August 2004. John serves as a Contract Attorney for Taco Bell Corp. John received his J.D. in 1996 from Chicago-Kent College of Law, Illinois Institute of Technology and is licensed in both Illinois and California. Through his work with Taco Bell, John brings to H&L experience in franchise related matters such as, the drafting and negotiation of development

agreements, general real estate matters, federal and franchise laws, contract compliance with franchise agreements, enforcement efforts of trademarks, copyrights and trade dress. John also has experience in tax and corporate law through his work with the Chicago firm Dale & Gensburg, P.C.

Contact John at:  
[j.haraldson@holmeslofstrom.com](mailto:j.haraldson@holmeslofstrom.com)

**Catherine M. Carroll** is H&L's new independent contractor Paralegal with over 25 years of experience in franchise law and joined our firm in August 2004. Cathy received her B.A. from UC Irvine and her Paralegal certificate from UC Los Angeles in 1979. She has over 10 years of experience in real estate contract negotiation, document preparation for franchisor sites, including purchase agreements, lease agreements, and ancillary documents. She is also with Taco Bell Corp. as a contract paralegal. Contact Cathy at:  
[c.carroll@holmeslofstrom.com](mailto:c.carroll@holmeslofstrom.com)

**Christine C. Goldenberg** joined H&L in June 2004 and is the new addition to H&L's Administrative staff. She is a native of Los Angeles who graduated from Lewis & Clark College in Portland, Oregon in 2003 when she received her B.A. in Communication and minor in English. Christine works in the Long Beach office of H&L in Administration & Events and her duties include answering telephones, managing attorney calendars, coordinating itineraries for travel and events, human resources, and assisting attorneys with client matters. In addition, Christine is responsible for coordinating H&L events, such as, the Quarterly IFA Breakfast in Orange County and Dinner in San Diego. Christine is also responsible for the production of the firm's Newsletter. Contact Christine at:  
[admin@holmeslofstrom.com](mailto:admin@holmeslofstrom.com)

## CREATING A WINNING FRANCHISE CULTURE, continued from page 1

- Your organization will have a distinctive advantage over competitors who are less unified and have either a non-supportive or a passive culture.

### Essential Elements of a Winning Culture

As I have studied organizations inside and outside of the franchising world, I have repeatedly seen the same themes emerge from successful businesses. The opposite is also true: businesses that don't exhibit a strong commitment to these cultural elements rarely produce extraordinary results over an extended period of time.

A Shared Vision: Ken Blanchard, in *The Heart of a Leader*, states that "All great companies and teams have a visionary leader at the helm, who is always pointing to the kind of organization they're going to be." This is of even greater importance to a franchise organization, where people from potentially all over the world must align their own personal hopes and dreams with the vision of the franchise organization.

Value-Based Leadership: Positive, consistent beliefs and behaviors will support and solidify operating processes and procedures. As with our children, who watch our every move and seize upon every inconsistency, our franchisees will spot any behaviors, policies and strategies that run counter to their expectations and this will seriously undermine the trust that is so critical in the franchise relationship.

People Centered Approach: The most successful organizations have an almost fanatical focus on people – employees, customers, franchisees, business partners. Sadly, many franchise organizations focus all of their attention on their numbers and processes while failing to realize it's the people who

produce the results. Franchise organizations that treat their people exceptionally well find that their people in turn treat their customers and partners with great value.

Exceptional Communication: In the business world today there are more ways to communicate than ever before, and this often leads to less real communication. We often mistake an e-mail blast or voice mail for effective communication, and this is especially dangerous for franchisors whose operations extend outside their own country. Exceptional communications in the franchise world include regular face-to-face interaction, consistent open and direct dialogue between the franchisor and franchisees as well as within franchisees, and active and broad listening to the concerns and needs of the network by the franchisor. In addition, cultural, language and time zone differences are also well-planned out and timed.

Excessive Encouragement: Benjamin Zander, Conductor of the Boston Philharmonic and a renowned speaker and author, stated that his primary role as a leader of the orchestra is to be a "dispenser of enthusiasm"! Franchisors must implement systems of reward and recognition that provide constant encouragement and a focus on achievement. Whether in the early days of a franchisee's business or the mature stages of slower growth or struggle, franchisees need to be publicly valued, recognized and rewarded constantly.

Shared Learning: Many franchisees feel the greatest value they receive as part of their franchise system is the opportunity to learn and grow from the experiences of their peers. A franchisor that fosters and facilitates the sharing of ideas, best (and "worst"! ) practices, financial and performance data will experience the velocity of learning that will give it a distinct

competitive edge.

### Creating and Maintaining a Winning Culture

The starting point in any important endeavor is commitment – to change or a course of action. Franchisors who desire to run exceptional networks must recognize the importance of culture in their business and place it at the top of their strategic imperatives. Key elements of your culture must be woven into all activities and communications, training materials, field engagement and network-wide meetings and events.

Next comes modeling: talking the talk. Every aspect of the business, from the Corporate headquarters to field engagement to personal communications and system-wide events must impart and embody the elements of the desired culture that franchisees will need to replicate. Franchisees should be able to sense, feel, and see attributes of your winning culture in every encounter, beginning with the very first prospect inquiry, the pre-award visit and initial franchise training.

Lastly, and perhaps most importantly, your winning culture will be dependent upon the type of people you hire, especially the senior executive team who set the tone and vision for the rest of the franchise organization. Maintaining a team of franchise professionals who care deeply about the success of the franchisees above all else will go a long way to creating a winning culture that produces consistently extraordinary operating performances.

**Gene Longobardi** is President and CEO of Kidz Online International, Ltd. an online teen education training franchisor. He is also a business advisor to franchise organizations and education companies.

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For the past 12 years he has served in various executive positions with a major international education franchisor and was honored with an annual award bearing his name. Contact Gene by phone at: (714) 731-1919, or by e-mail at: genelongo@pacbell.net

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## FRANCHISEE ADVISORY COUNCILS

By: David E. Holmes

We often share with our clients some of the lessons we've learned over the years as to the "best practices" in franchising. Those tools and techniques are supportive of success in building a franchise system that operates in the long-term best interests of both franchisors and franchisees. While these techniques may not strictly come under the heading of legal advice, they definitely can be of benefit to most systems as they go through the growing pains involved in expansion and development.

One of the best techniques we see utilized by successful franchisors is the Franchisee Advisory Council (FAC), a group of franchisees who provide advisory input to a franchisor regarding operation of the system, retail marketing matters, issues of concern to franchisees, etc.

Franchise Advisory Councils can be organized by the franchisor or by some industrious franchisees with franchisor consent. A "typical" FAC has members elected by the franchisees, generally on a regional basis with one representative from each region. Its function is strictly advisory, and the franchisor is not legally required to bring any issues to the FAC nor is the franchisor bound by any input the FAC although these vary from system to system.

In setting up a FAC, a franchisor should consider issues such as the following:

- How the FAC's activities are funded. Typically, the franchisor funds initial organizational steps, such as possible incorporation, drafting of bylaws, etc., and reimbursing certain expenses incurred by FAC members, such as travel.
- How the FAC is organized, whether it is separately incorporated, what its bylaw provisions should be, how members are elected and replaced/removed if no longer in good standing in the system, etc.

As a practical matter, wise franchisors understand that whatever is written in their franchise agreements, they and their franchisees share common interests and objectives. Open channels of communication are vital.

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**Well-managed franchise systems use FACs to assist them and make them stronger, and stronger systems have a significant advantage over their competitors.**

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### Specific Benefits Include:

- Defusing issues that can, if left un-addressed, create dissension within a system and an "Us vs. Them" mentality, driving a wedge between the franchisor and its franchisees.
- Serving as a sometimes needed "reality check" for the franchisor as it develops new programs and marketing strategies which may or may not be practical from a retail standpoint.
- An organized source of good new ideas for the operation and marketing of retail units.
- Creating allies for the development of new programs and marketing strategies reviewed and endorsed, by the FAC.
- Effectively managing "peer

pressure" to help convince recalcitrant franchisees to comply.

Our experience demonstrates that most large and successful franchise systems benefit from the use of FACs. We, therefore, generally suggest the following to our clients:

- A clause in the standard form franchise agreement, allowing (but not requiring) the franchisor to organize a FAC and a "FAC Trump" provision which states that if the franchisor chooses to put a proposal before an elected FAC, and the FAC approves it, the franchisees are bound by it. Note: insertion of such a clause may require introduction/update of certain definitions to the FA, including "Business Judgment", "Good Standing" and "Input" and others. For example, the definition of "Good Standing" includes "Manuals" and "Franchisor-Related Persons/Entities". In addition, a reference to the FAC Trump provision should be in the UFOC.
- Franchisors should review the International Franchise Association's materials on FACs, as available on its website: [www.franchise.org](http://www.franchise.org)

It should be noted that no legal proceeding that we are aware of has interpreted "FAC trump" clauses and thus any potential enforceability issues are unknown. Until "tested" by such interpretation, this should be kept in mind and careful drafting to bolster enforceability should be utilized for such clauses.

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# FRANCHISE LEGAL UPDATES

## TERRITORIAL RIGHTS AND POTENTIAL FRANCHISOR COMPETITION

A recent New York case, Carvel v. Noonan (CCH Bus. Fran. Guide ¶ 12,912), gave the franchisor considerable freedom in structuring its product distribution system, confirming the franchisor's right to use potentially competing channels to distribute its products to consumers.

Carvel was sued by three franchisees who contended that Carvel's decision to place the product in supermarkets constituted interference with the franchisees' relationships with existing or potential customers.

A New York appellate court decided that Carvel's actions were not a crime or independent tort, and were not the sort of wrongdoing that would support a claim by the franchisees, at least in the absence of an unlawful act or evil motive.

The court noted that even though distribution by Carvel of products through non-franchised channels might be inconsistent with the franchisee-franchisor relationship, the relationship was an inherently complex one, that did not preclude all competition by the franchisor. The extent to which competition by the franchisor was allowed should be determined by the franchise agreement.

This court's deference to the franchise agreement highlights the importance of the franchise agreement's provisions regarding territorial rights to preserve the franchisor's right to remain involved in activities that might impact the franchisee. As usual, careful drafting of those clauses is absolutely critical.

## Non-Competition Agreements

Two separate cases, in two states, enforced non-competition agreements against franchisees. The lessons for franchisors are threefold:

First, other states are generally more accepting of non-competition agreements than California.

Second, the portion of the franchise agreement which specifies which law applies to the agreement can be of critical significance. If California law is specified, enforcement may be doomed.

Third, some courts are receptive to arguments that non-competition agreements are a critical part of the franchising business model and can serve to protect the entire system. This attitude is taking into account the interests of the entire system and not merely those of a break-away franchisee.

Here are the cases:

In Boulangier v. Dunkin' Donuts (CCH Bus. Fran. Guide ¶ 12,915), after selling his three New York units, the franchisee moved to New Hampshire and contacted a competing donut shop franchisor about franchise and employment opportunities. After the competing donut shop franchisor learned of the noncompetition provisions in the franchisee's franchise agreements, it terminated the discussions. The former franchisee then sued the original franchisor, asking the court (in Massachusetts) to declare the noncompetition provisions unenforceable.

The Massachusetts court decided that the provisions in the franchise agreement, restricting the franchisee from owning or working for competing businesses within five miles of any franchised location for two years after the franchise agreement's expiration, were necessary to protect the franchisor's confidential

information. In addition, the court stated that the restrictions were reasonable, not only because of their limited extent, but also because they protected the franchisor's system.

Petland v. Hendrix (CCH Bus. Fran. Guide ¶ 12,904) provided additional support for a post-termination noncompetition provision. Here, an Ohio court decided that a franchisor was entitled to an injunction preventing a terminated franchisee from operating a competing store in the same location he had operated as a franchisee, thereby upholding the noncompetition provisions of the franchise agreement.

The court noted that the provisions would not prevent the former franchisee from using his skills and experience in pet retailing in other markets, and did not destroy his sole means of support. More importantly, the court commented that the noncompetition provision was an integral part of the franchisor's business model, and therefore was reasonable, since it did no more than was necessary for the franchisor's protection, did not cause unreasonable hardship for the franchisee and did not injure the public.

Notably, the court determined that even if the franchise agreement was an adhesion contract, the noncompetition provision was enforceable since there was no evidence that the franchisor fraudulently induced the franchisee's agreement.

## TAIWAN FRANCHISE DISCLOSURE GUIDELINES

Taiwan is one of the more recent nations to adopt such a regulatory structure, although in this case the regulations are relatively limited, when compared to those of other countries.

On August 20, 2004, the Taiwan Fair Trade Commission released

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amended "Standards Governing Disclosure of Information by Franchisers." (Note: the non-standard spelling of 'franchisor' in the translated version of the Standards.)

The main provisions of the Standards include the following:

#### Disclosure

Ten days before the franchisor and the franchisee enter into contracts, the franchisor must provide written information to the prospective franchisee in the following areas:

- Historical information on the franchisor
- Information regarding management personnel
- Information on intellectual property rights
- Contents and methods of management assistance, training, etc. provided to the franchisee.
- "The franchisor's management program.
- Lists of franchisees and statistical information .
- Restrictions on the business relationship between the franchisor and franchisee in their operations of businesses.
- Information regarding "means to modify, terminate and/or rescind" the franchise agreement.

#### Review Period

Before the franchisor signs the franchise agreement, it must give the prospective franchisee five days to review the proposed contract.

#### Legal Consequences for Non-Compliance

Non-compliance with the Standards, which involves "concealment or delaying disclosure" and which "is clearly unfair to the trading counterparts and which is sufficient to affect the trading order of the franchising operations" is a violation of the Taiwan Fair Trade Act. Note: This provision may introduce a

"materiality" element, not expressly included in North American, or many other franchise disclosure laws.

#### Conclusion

The Standards contain a number of ambiguities and it will be interesting to see how they are ultimately resolved. In addition, it appears that the Standards apply to awards of Master Franchises in Taiwan, as well as, unit franchises by franchisors based either in Taiwan or abroad. Compared with the U.S. and Canadian laws the relatively small number of areas covered in the disclosure is remarkable.

## LESSONS FROM LAWSUITS

One way to look at franchisor/franchisee litigation is to see it as a series of lessons, often on what not to do in franchising. While those lessons may have been remarkably expensive for the parties involved in them (even if they won), these lessons are offered to us for free.

#### Case 1: "Sort of" Awarding a Franchise

In Ross v. Culver Franchising System, CCH Bus. Fran. Guide ¶ 12,895, a franchisor was accused of wrongfully terminating a "franchisee" and successfully defended that no franchise was ever awarded, therefore, Illinois law provisions requiring termination with "good cause", notice and an opportunity to cure were not applicable. The court agreed.

The prospective franchisee had received a letter from the franchisor stating that it had been granted "operational approval to become a Culver's franchisee to begin training in our August class" and that the next step would be to schedule the signing of the franchise agreement.

The prospective franchisee claimed that he was a "franchisee" and

had been "terminated" in violation of applicable law, because the franchisor failed to allow him to attend training. The court noted, the prospective franchisee never signed the franchise agreement or paid the initial franchise fee. In addition, the letter was not a contract to award a franchise, since it was indefinite and failed to specify a location, duration, renewal rights and payment of the franchise fee, among other things. On this basis, the court concluded that no franchise ever existed.

#### The Lesson: Be Clear as to a Prospect's Status

While the franchisor prevailed, it was only after being dragged into a lawsuit, spending substantial resources to defend itself and possibly having had to disclose the litigation in its UFOC.

The lawsuit might have been avoided if the franchisor had been more careful in the language it used in its letter. Franchisors should use "boilerplate" language indicating that a review committee had preliminarily approved the application, but that no franchise rights would be awarded to the prospective franchisee until the franchise agreement was signed by the franchisee and the franchisor, and the initial franchise fee paid.

#### Case 2: Did I Really Agree to Arbitrate?

Asia Pacific v. Rainforest Cafe, CCH Bus. Fran. Guide ¶ 12,892. Here, a restaurant franchisor was involved in a dispute with an individual it had asked to help it in identifying a potential franchisee in Asia. The dispute was over a claimed \$1,000,000 fee the individual maintained was due him for finding the franchisee.

In an exchange of letters, General Counsel for the franchisor said that "Lyle asked me to review this file and to respond to your request for arbitration. We believe that an arbitration in Minneapolis would be

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# TOP 10 DOs & DON'Ts FOR BUSINESSES

By: Lori M. Lofstrom

1. **DO** request that your bank statements end on the last day of the month for easy monthly reconciliation and accounting. With the increase in incidents of employee fraud, you should also take the following steps to safeguard your hard earned cash:
  - i) reconcile bank account statements regularly and promptly ensuring that employees signing checks are not also responsible for reconciling the account; and
  - ii) allow only authorized personnel to change check-printing vendors.
2. **DO** put the interest rate you charge for late payments on your invoices. This allows you to recover interest if you ever have to sue to collect the debt.
3. **DO** register your domain name in your own individual or company name – do not allow your website service provider to register it in their name. We have seen situations where domain names have been “held hostage” in disputes regarding an account.
4. **DO** be sure to follow special limitations on S-corp share ownership.
5. **DO** keep in mind that California has unique provisions regarding the number of directors.
6. **DON'T** raise capital by promising to sell friends and family (or others) more than 100% of any given class of your stock.
7. **DON'T** use “clip art” for any element of your trademark. Always use the <sup>TM</sup> or <sup>SM</sup> next to any unregistered logo, slogan, product or service name you are using to protect your common law rights and counter the “innocent infringer” defense. The ® is used only for marks registered with the United States Patent and Trademark Office, not marks registered with any of the individual states. Use the copyright notice on any textual materials you may have: © + (year) + (the name of the company or individual owner of the mark).
8. **DON'T** proceed on the basis of a verbal partnership if your interest is other than a 50/50 split. Even if your 50/50 partnership is recognized by the state you are in, it's prudent to have the relationship memorialized in writing to document any “special issues”.
9. **DON'T** be fooled by bogus “annual minutes compliance” services on “official looking” forms. The forms are generated by private companies that misleadingly give the appearance that they are a governmental or government-related agency.
10. **DON'T** neglect to file your annual Statement of Information with the Secretary of State of California for your corporation each year or for your LLC every other year. These requirements change frequently. Failure to do so can result in assessment of a penalty of \$250 or more, plus interest and other fees.

\* **Special Thanks To:** Peggy J. Karavanich, H&L Paralegal, for her assistance with this article.

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a workable process for resolving this dispute and as such we have turned it over to our counsel ... so we can discuss the ground rules for arbitration.”

A disagreement erupted over whether or not there was an agreement to arbitrate. The court decided that any reasonable party would conclude that there was an agreement to arbitrate, with the lawyers assigned to resolve the details.

## The Lesson: Clear Communication Between Counsel & Client is Critical

One of two things should have happened: If the franchisor had not yet decided to arbitrate, it should have said, perhaps, in the following manner:

“We’ve not made a decision yet, but will discuss our alternatives with outside counsel and will get back to you.”

Alternatively, if the franchisor was agreeable to arbitration, it shouldn’t have renege on the

commitment made in the letter.

## Case 4: When is a Rebate a Bribe?

This case, Substantial Investments v. D’Angelo Franchising (CCH Bus. Fran. Guide ¶ 12,897) is perhaps of greatest concern. A sandwich shop franchisor allegedly had an arrangement with one of its suppliers in which the supplier “kicked back” a portion of the delivery fees paid by franchisees of the system. The franchisees claimed that they were compelled by their franchise agreements to

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