FRANCHISE LAW INSIDER™

A Publication Reviewing Recent Franchise and Related Business Developments 2nd Quarter 2005

"Leaders need to be optimists. Their vision is beyond the present."
- Rudolph Giuliani-

HOLMES & LOFSTROM, LLP
Franchise and Business Counsel

IFA QUARTERLY EVENTS
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April 20, 2005
BANKRUPTCY ISSUES IN FRANCHISING

LOCATIONS:

Orange County Breakfast
New!: Scott's Seafood Grill & Bar
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

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INSPECT WHAT YOU EXPECT...MYSTERY SHOPPING FOR YOUR BUSINESS

By: Leslie Leggate & Troi Lynn Ozburn,
National Shopping Service Network, LLC

In the evolving world of business, maintaining a competitive advantage and knowing what your customers are thinking is of utmost importance. Mystery shopping is a tool that has gained popularity in mainstream markets and provides that important edge. Historically, mystery shopping has focused solely on the end product of customer service. Today, mystery shopping has evolved into much more. Companies in all industries (from restaurants to home repair and product manufacturers) are not only using mystery shopping to measure the end product of customer service, but as a tool to measure the process of delivering that customer service. When you analyze how employees deliver customer service through the eyes of your customer, you are able to collect invaluable information that can be used to analyze marketing, employee training, company branding, product compliance, competitors' practices/procedures and much, much more. Mystery shopping accomplishes this by sending an unidentified, typical consumer to review your company based on the criteria you have set out as part of your mystery shopping program. The shopper will complete the shop as instructed and will report information back as specified by your program.

Choosing a Mystery Shopping Company That's Right for You

This is perhaps the most important step in any mystery shopping program. We recommend choosing a company that will work side by side with you to create a program that is right for you. Although mystery shopping may appear simple, most programs are very complex in design and operation. Each company and its subsidiaries have a unique set of challenges and method of operation. Each individual location will face a different set of socioeconomic, geographic and community value issues. A good mystery shopping company will act as another member of your management team to help you address how these external factors impact your business. Choosing a mystery shopping company that will work closely with you and offer suggestions as your program evolves can make a huge difference in the effectiveness of your program. Because of technological advancements, companies no longer need to feel limited to choose a mystery shopping company in their immediate geographical location.

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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.

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Mystery shopping today is administered primarily through the Internet, although the actual mystery shopping is often done by phone or in person. A good mystery shopping company will be able to find a shopper anywhere in the United States and international mystery shopping companies will be able to find a shopper in a number of countries outside of the United States as well.

You Get What You Pay For

Mystery shopping services can come bundled in a number of different packages with a number of pricing options.

Cookie cutter programs tend to be very economical but are rarely effective in providing you with solid, usable data. With cookie cutter programs your options will be limited and you will have minimal ability to adapt the program to suit your specific needs. Most of these types of programs have forms that are comprised of yes and no questions. They allow little, if any, opportunity for comments to be communicated to you from the shoppers. You will receive basic information on this type of program, but there is little depth to the information and minimal customer insight obtained. Cookie cutter programs are generally designed for ease of the mystery shopping company and rarely have the company's growth and best interest in mind. General programs are also available. With a general program you will be allowed to have more control over the questions that are asked, and will receive more narrative responses/comments from the mystery shopper. You are often limited to the number of questions you can ask of the shopper thus the mystery shopper will be limited in what they are able to communicate to you. There will be a broad range of programs that fall into this category.

Tailor-made or customized programs are the mystery shopping product of choice. With tailor-made programs, the only limits that are placed on the program are those created by modern technology. A tailor-made program is built from scratch and is designed to address the company's individual and unique needs. The company's best interest is the focus of this type of program. Tailor-made programs are cut to fit and still work well with your budget because they are customized to suite the level of service required.

Because the management information that you need is far too valuable to take shortcuts, we highly suggest choosing a provider that offers tailor-made programs. Choosing a mystery shopping company that will not only develop a program specifically for you but will also assist you in compiling management data in a useable format will benefit you tremendously.

Creating a Tailor Made Program

Before mystery shoppers are sent through the front door of your (or your franchisee's) businesses, there is a lot of work to be done. Meeting with your mystery shopping company is an absolute necessity and this meeting could involve your franchisees. This meeting can be in person, by phone or through Internet technology. Set aside time to explain how your business operates, what challenges you face and what sets you apart from other companies like yours. The more communication between you and your mystery shopping company the more they will be able to understand and address your issues. The perfect mystery shopping company will use a programming specialist to begin the process. The programming specialist works intimately with you to understand how your company

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to understand how your company works, what its challenges are, what your goals are, what your budget is, and how to best go about implementing an effective mystery shopping program.

Programs vary tremendously in complexity. Some of the less complex programs involve sending in a mystery shopper to provide you with specific feedback by filing an online form for your business. Other programs may involve checking compliance, monitoring phone calls, taking pictures, providing you with documents, testing for integrity issues and other in-depth processes. It is highly recommended that you choose a company that will continually work with you to develop and alter your program as your needs change and your business grows.

Once your needs, challenges and goals have been identified, the creation stage begins. There are many dynamics that must be considered. There is a knack to creating well-drafted questions to target specific information. Rely on your mystery shopping company's expertise to guide you when it comes to asking questions of the shopper. A well-drafted form can avoid unnecessary mistakes in data gathering and give you pinpointed, useful information from your very first shop.

Test Drive Your Program

Would you consider buying a new car before you had a chance to take it for a spin around the block? For most of us the answer is no! Take a spin around the block with your program first to see how it handles. Once you have created the form and have the basic design for your program thought out, send a mystery shopper to do an actual shop. This shop will provide invaluable feedback on your program. It allows you to see how the program held up, if any elements may have been overlooked, identify other issues and finalize your program. Taking the time to do a test shop or a short pilot of the program can avoid costly errors when launching your full program.

How Frequently Should I Shop?

The more the better, right? Wrong! If a mystery shopping company suggests you should do as many shops as possible, grab your wallet and run! The most effective mystery shopping programs are those that are consistent in the number of shops being completed. The mystery shopping company can work with you to determine how large your sampling should be to provide you with an accurate picture of your business. Consistency of shopping cannot be emphasized enough.

If your company has limited resources, don't feel like you can't implement an effective mystery shopping program. If the program is structured correctly, limited resources will have little, if any, impact on the effectiveness of the program. If you have limited resources, commit to doing a monthly number of shops that is within your budget and work from there.

Depending on the volume of business that your company does, your ideal frequency may be as few as 1-3 shops per month and for others it could range from 10 – 500 + per month. Sporadic shopping (10 shops this month, no shops the following 3 months and then 20 shops the next month) is not as effective because it does not provide consistent feedback over the course of time and will devalue the program. We like to refer to it as taking a measurable snapshot of a moment in time. Obtaining consistent snapshots of moments in time will provide more usable feedback than will sporadic snapshots.

What Does the Mystery Shopping Company Do After the Program is Created?

Once the program has been created and tested, it is time to roll out the full project. The mystery shopping company screens its contract shoppers to find a qualified mystery shopper for the job. This shopper receives individual training and reviews a comprehensive set of instructions prior to completing the shop. The shopper then completes the assignment and files it with the mystery shopping company. A good mystery shopping company will run the report through a quality control process.

This timeframe is perhaps the most important and during this period all reports are scrutinized for content and communication between all parties must be clear. The mystery shopping company's account manager will work closely with the mystery shopper to ensure a good quality report. It is critical to choose a company that works with their mystery shoppers to provide you with the best data possible.

While it is important to not cut corners or rush this process, it is also critical that your mystery shopping company offer quick turn around time and makes accessing the report and data convenient for you. Each mystery shopping company will have a slightly different system to post reports for your review. We suggest choosing a mystery shopping company that allows you 24/7 password protected access to the reports at no additional charge. The mystery shopping company should also offer full online management of your reports, including full printing and email capability to send the reports to whomever you choose. In addition, they should also offer

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advanced reporting, comparative charts, graphs and/or basic data reporting., comparative charts, graphs and/or basic data reporting.

So What Now?

With the actual process of the mystery shop and data collection behind us, we must now take a detailed look at the information gathered. Having the mystery shop complete does not mark the end of the process, but rather the beginning. The next step is to take the data, knowledge and power from the mystery shops, set and evaluate goals and make it actionable.

Look for our second article in the 3rd Quarter 2005 Franchise Law Insider – Getting employees to support a mystery shopping program and exploring the franchisee/franchisor relationship in the context of a mystery shopping program.

Want more information? Contact Troi Lynn Ozburn at (888) 299-1072, or Troi@mysteryshopper.net
Leslie Leggate at (888) 339-1072, or Leslie@mysteryshopper.net

SECURITY INTEREST IN A FRANCHISEE'S RIGHTS UNDER A FRANCHISE AGREEMENT

By: John G. Haraldson, Holmes & Lofstrom, LLP.

Franchise agreements usually contain anti-assignment provisions that prevent and/or void a transfer of the rights granted to the franchisee to a person or entity not approved by the franchisor. These restrictions are necessary to prevent the transfer of franchise rights and obligations to an unqualified operator.

In addition to the typical transfer between two individuals or entities, the anti-assignment provisions also may apply where a lender seeks to take a security interest in a franchisee's rights under a franchise agreement. If successful, the lender would be able to succeed to the rights and interest of the franchisee if the franchisee defaulted under the loan. Essentially, the lender would step into the shoes of the franchisee by foreclosing upon and taking possession of the business, after which the lender could resell the business or operate indefinitely. Understandably, many franchisors use their anti-assignment rights to prevent lenders from taking a security interest in the franchisee's rights under the franchise agreement in order to avoid this situation.

However, where franchisors restrict a lender's ability to obtain a security interest in the franchisee's rights under a franchise agreement, franchisee's have reduced access to financing (both in terms of the amount of financing available and in the favorability of the terms under which they are able to borrow money). Article 9 of the Uniform Commercial Code ("UCC") previously did not cover this kind of transaction, leaving a franchisee on its own in dealing with the dueling interests of the lender and the franchisor. When the UCC was recently revised, the drafters sought to balance these competing interests by setting out the circumstances under which a lender would be allowed to obtain a security interest in a franchisee's rights in a franchise agreement.

Under revised Article 9 of the UCC §9-408(a), a lender may obtain and perfect a limited security interest in a franchisee's rights in a franchise agreement. Section 9-408(a) works by rendering the anti-assignment provision ineffective if that provision impairs the creation, attachment or perfection of a security interest or provides that the creation, attachment, or perfection of a security interest gives rise to a default under the franchise agreement.

Although assignment may be permitted in these instances, the security interest that a lender obtains is substantially limited. Under UCC §9-408(d) which provides that the security interest 1) is not enforceable against the franchisor; 2) does not impose a duty or obligation on the franchisor; 3) does not require the franchisor to recognize the security interest, pay or render performance to the lender, or accept payment or performance from the secured party; 4) does not entitle the lender to assign the franchisee's rights under the franchise agreement; 5) does not entitle the lender to use, assign, possess or have any access to the trade secrets or confidential information of the franchisee or franchisor; and 6) does not entitle the lender to enforce the security interest (i.e., by foreclosure).

These restrictions protect the franchisor's interest in ensuring only qualified operators may run the business and allow for a limited security interest as described above. The limitations ensure that a franchisor will not be forced to permit the transfer of the franchise business to an unacceptable transferee. Further, a franchisor is free to exercise any legally binding contractual rights it has in the franchise agreement; for example, default or termination for non-compliance with the franchise agreement terms. In addition, a franchisor may provide that a lender's attempt to enforce the security interest would trigger a default under the franchise agreement.

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Given all the limitations of the security interest, what is the value to the lender? Essentially, the lender gets a secured interest in the proceeds of any sale of the franchised business.

While the UCC provides substantial protection to franchisors, a franchisor must still act to protect its own interests. It would be prudent for a franchisor to negotiate for the inclusion of a provision in the security agreement or draft a side letter that specifies the security interest in the franchisee's rights in the franchise agreement is specifically limited as described under UCC §9-408(d). An example of such a provision follows:

"The parties acknowledge and agree that any security interest granted by the Borrower to the Lender with respect to the Borrower's rights under and franchise, license, or similar agreements are granted in accordance with Section 9-408 of Revised Article 9 of the Uniform Commercial code and are subject to all limitations on enforcement and other restrictions contained therein. Further, the parties acknowledge and agree that any attempt by the Borrower to waive the limitations on enforcement and other restrictions imposed on the Lender by Section 9-408 of revised Article 9 of the Uniform Commercial code are deemed void and of no force or effect unless those limitations or restrictions are explicitly waived in writing by all parties to the affected agreements."

A franchisor may also wish to file its own security interest. That security interest may include a security interest in the franchise royalties, trademarks, and other intellectual property. To do this, a franchisor should revise its franchise agreement to include an authorization to file a security interest and include a statement in the franchisor's UFOC relating, to the effect, that security interest may have in the franchisee's ability to obtain financing. The effect of filing a security interest in franchise royalties is to make the gross revenues of the business less available as collateral to other creditors.

It is likely that if the franchisor does file a security interest as described above, a lender will ask the franchisee to subordinate that security interest to the lender's interest. Depending on the circumstances, this request may be reasonable (for example, if subordination would be required to get financing to purchase and open the franchised business). Even a subordinated security interest puts the franchisor in a stronger position than a franchisor that has no security interest. A franchisor that has no security interest is relegated to the unsecured creditor status in the event of a bankruptcy. On the other hand, a franchisor with a subordinated security interest is much higher in priority that a general unsecured creditor in the event of bankruptcy. Further, prior to filing for bankruptcy, the franchisor would have the ability to foreclose (subject to certain limitations not discussed here) and take over the business for its own account or to resell it to another operator. Note that the franchisor would not be subject to the same limitations on enforcement as under the lender's limited security interest.

Specific Recommendations

1. Require that any security agreement that purports to take a security interest in a franchise or license agreement include language specifying that any security interest in the franchise or license agreement is limited in accordance with the provisions of Revised UCC Section 9-408.
2. Update the standard form of franchise and license agreements to permit the filing of a security interest on a go-forward basis.
3. File UCC-1 statements taking an interest in the franchise fees, marketing fees, royalties and other rights granted to the franchisee under the franchise agreement.
4. Allow the security interest to be subordinated when appropriate.

FRANCHISE LEGAL UPDATES

PROPOSED LEGISLATION TO ASSIST VETERANS' PURCHASES OF FRANCHISES

Legislation that would allow U.S. veterans to use part of their educational benefits to pay for training costs connected with purchasing a franchised small business has been introduced in Congress. As expected, has received support from the International Franchise Association.

The "Veterans Self-Employment Act," a bill recently introduced by U.S. Rep. Richard Baker (R-La.), would establish a five-year pilot program to allow American service members, veterans, national guardsmen, reservists, and others to use part of their Veterans Administration educational assistance funds to defray training costs associated with obtaining a franchised small business.

The proposed act would allow veterans and eligible dependent spouses or children to apply some of their educational benefit to defray the portion of a franchise purchase cost attributable to training.

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Specifically, in a one-time, lump-sum payment, beneficiaries would be able to use the lesser of one-third of the remaining Montgomery GI Benefit entitlement or half the franchise fee.

A previously existing program has allowed more than 270 franchised small businesses to be acquired by veterans through the Veterans Transition Franchise Initiative, known as VetFran, a financial-incentive program created by IFA to encourage franchise ownership by former military personnel. More than 150 franchise companies offer discounts through the program, ranging from reduced initial fees to waived training costs.

Franchise systems should be aware of these programs and may wish to use them to facilitate the transition of veterans from military to civilian life. Franchise systems find veterans attractive as prospective business owners due to their military experience which engenders organizational skills, teamwork and mission-focus, the association says. Depending on the content of any legislation passed, franchise systems may need to re-structure their offering to specifically identify training-related costs.

NEW ITALIAN DISCLOSURE LAW ON FRANCHISING

By: Prof. Avv. Aldo Frignani

On May 25, 2004, Italian Law no. 129/2004 on franchise agreements ("the Law") entered into force.

This long-awaited legislative text reflects two conflicting approaches emerged during its drafting. Although, in fact, the main purpose of the Law is to provide a minimum set of pre-contractual disclosure obligations binding on both parties to a franchise agreement, it also deals with some substantial aspects of franchise contracts.

More specifically, the Law sets out the following main provisions.

Definitions. It is the first time an Italian law lays down a definition of franchising. This encompasses every business relationship among two legally and financially independent undertakings, whereby a franchisor grants a franchisee the licence of a bundle of intellectual or industrial property rights, together with the necessary technical and commercial support. Key notions related thereto, such as know-how, royalties and entry fee are also defined.

Scope. Master franchising and corner franchising contracts are expressly defined as falling within the scope of the new law, so as to ensure protection to all franchisees as well as master franchisees bound to invest in Italy

Form. Franchising contracts must be in writing, failing which they shall be null and void.

Test. The Law expressly requires the franchisor to have tested his business concept on the market before a franchising network can be set up. No minimum testing period is required, but this is deemed to include at least one fiscal year.

Minimum Duration. The duration of the agreement must be sufficient to amortise the investments, and in any event cannot be less than three years.

Contents of the Contract. The contract must expressly deal with a number of items: (i) the initial investments and costs; (ii) the terms for the calculation and payment of royalties, as well as the minimum proceeds, if any, to be reached by the franchisee; (iii) the territorial exclusivity, if any; (iv) the specification of know-how and other services performed by franchisor under technical and commercial assistance, design, set-up and training; (v) the criteria, if any, to acknowledge the franchisee's contribution to franchisor's know-how; (vi) the terms for the renewal, termination, as well as assignment, if any, of the contract. However, the Law does not prescribe any specific contents for each item, recognising the parties' freedom to choose the assessment of their reciprocal interests as they think it fits best.

Franchisor's Obligations. The Law requires that 30 days prior to the signing of the agreement, the franchisor hand to the prospective franchisee a copy of the contract and attachments thereto, containing the following mandatory elements: (a) relevant information regarding the franchisor, including, upon franchisee's request, copy of his balance sheet in the previous three years; (b) trademarks used in the system; (c) characteristics of the business; (d) a list of current franchisees and franchisor's directly managed outlets; (e) the annual variations in the number of franchisees with their locations and addresses in the past three years; (f) a summary of judicial or arbitral disputes concerning the franchising network which were concluded in the past three years. The Law also provides that specific rules will be set out with regard to information to be provided by franchisors who in past operated exclusively outside Italy.

Franchisee's Obligations. These comprise a location rule and a confidentiality obligation on the franchisee and his employees with regard to the franchising business, during and after termination of the contract.

Pre-Contractual Obligations. Both the franchisor and the franchisee are charged with the duty to behave with "goodwill, fairness and good faith" and to disclose all

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KUDOS TO OUR CLIENTS!

These are just a few of our clients' most recent and major accomplishments:

AIM MAIL CENTERS: Michael Sawitz, President

AIM has not only outlived more than half of the Fortune 100 companies that opened the same year as AIM, but it has reached 100 franchise units. A true "survivor".

ONLINE TRADING ACADEMY: Eyal Shachar, President

In March of 2005, OTA opened their first franchise in Dubai of The United Arab Emirates. The Grand Opening for their new location in Dallas, Texas is scheduled for the week of April 11, 2005.

MAKE THE GRADE: David Serwitz, President

Make the Grade is one of H&L's "start-up" franchise clients, and they are pleased to announce that as of March 1, 2005 they sold their very first franchise!

IT'S A GRIND: Steven Shoeman, CEO

IAG is pleased to announce the opening of their 50th franchise store, as well as, selling their 100th franchise.

Holmes & Lofstrom, LLP wishes all our clients a heartfelt congratulations, and much continued success in the future!

FRANCHISE LEGAL UPDATES, continued

information necessary for the purposes of the franchise agreement to the other party.

Conciliation. The parties may agree on an attempt to settle any disputes arising from the contract through conciliation mechanisms in the competent Chamber of Commerce, before filing a suit or requesting an arbitration.

Annulment of the Agreement. If one of the parties to the agreement provides false information, the other may ask for annulment of the contract as well as damages, when these are due.

The new law is immediately binding on contracts entered into after its coming into force. Existing contracts will have to be amended within one year so as to fully comply with the new legislative requirements.

CLASS ACTION LEGISLATION PROPOSED IN FRANCE

For many years, Franchisors in the U.S. have been exposed to the possibility of class action litigation, in which one Franchisee represents not only on his own interests, but also those of other Franchisees, claiming the same injury and seeking the same relief. Class action lawsuits can be notoriously difficult and expensive to defend, and can threaten the Franchisor with enormous damages and/or court orders seriously affecting continued operation of the system. Abuses connected with class action lawsuits have, in fact, recently Resulted in corrective legislation in the United States.

In spite of these corrective efforts, the proposed enactment of legislation in France, and perhaps in other countries within the European Union, raises the real possibility of similar exposure in the largest market in the world.

In a recent address, French President Jacques Chirac requested his government to modify legislation so as to "enable groups of 'consumers' … to bring collective actions against abusive practices."

In response to this, the French Justice and Economy and Finance Ministries have assigned a task force responsibility to draft a bill allowing "group actions." Specific recommendations are due by July of this year and a bill is planned to be submitted to the French legislature by November.

No specifics regarding the bill are available yet. Depending on how the bill is drafted, "consumers" may include franchisees, in spite of the fact that they are generally businesspeople. Continued on page 8

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A law permitting class actions could be a significant legal tool possibly targeted for use against foreign-based Franchisors, which some French commentators have criticized recently.

Furthermore, there is the real possibility that any French legislation in this area might be followed by similar proposals, either on an EU-wide basis, or by individual countries. Sweden has already adopted such a law, although the UK rejected one, at least for the time being.

Certainly, that pattern was followed after France adopted a disclosure law (the *"Loi Doubin"*), which was subsequently copied in Spain and Italy. Adoption of a similar disclosure law is also likely in Belgium later this year. Therefore, the potential for further adoption of any class action legislation, if France moves forward, certainly exists.

H&L will watch this situation closely over the next few months and keep you advised.

MEXICO PROPOSED DECREE COVERING FRANCHISE RELATIONSHIPS

Franchise laws come in two major "flavors"; those regulating the offer and sale of franchises, generally mandating pre-sale disclosure, and those which attempt to regulate the post-sale relationship between the Franchisor and the Franchisee. (Note that some countries combine these two approaches in a single law or regulation.)

Recently, Mexico proposed certain changes to its laws what would address the franchise relationship. Among other things, this legislation, if adopted, would:

- Define a franchise broadly enough to include many traditional trademark licensing arrangements.

- Require the Franchisor to provide information to the Franchisee prior to signing of an agreement, the content of that information to be specified by regulation. Failure to provide this information, or the provision of inaccurate information would allow the Franchisee to void the agreement and, in some situations, claim damages.

- Specific provisions would have to be included in the franchise agreement, including the following;

- A specified territory, including "the criteria to determine minimum distances between the premises of the franchisees." (Would this outlaw franchise arrangements where no territorial rights are granted?)

- "Retail and wholesale prices, inventories and marketing and advertising, which shall be applicable in a uniform manner to the franchisees," (Would this disallow different retail price structures or marketing strategies in different markets?)

- "Methods applicable to determine franchisees' profit and/or commissions margins, which shall be uniform," (Will this prevent Franchisors from taking any steps which might differentially affect Franchisee's economic results?)

- "Procedures that guarantee the equity conditions regarding the recovery of the investments made by the franchisees." (We confess that we have no idea what this clause means!)

- Provisions restricting mandatory sale of the Franchisee's assets or stock to the Franchisor.

- A duty of confidentiality is imposed on the Franchisee,

Whether the Franchise Agreement can be for a specified terms and the Franchisee's rights expire without the Franchisor proving good cause is unclear.

INDIANA & GEORGIA TAX NEXUS

Indiana is now holding that royalty income received by a corporation for permitting subsidiaries to use its trademark was subject to apportionment for Indiana adjusted gross income tax purposes because the payments constituted business income. The tax payer had argued they were "non-business income.

Effective January 1, 2006 Georgia will disallow the deduction of intangible expenses and costs. IThis is similar to the royalty add-back statutes in that it applies to royalty payments paid to related parties (defined as having 50% equity interest in the payor.) It does not appear to affect independent franchisees although it would likely apply to company stores.